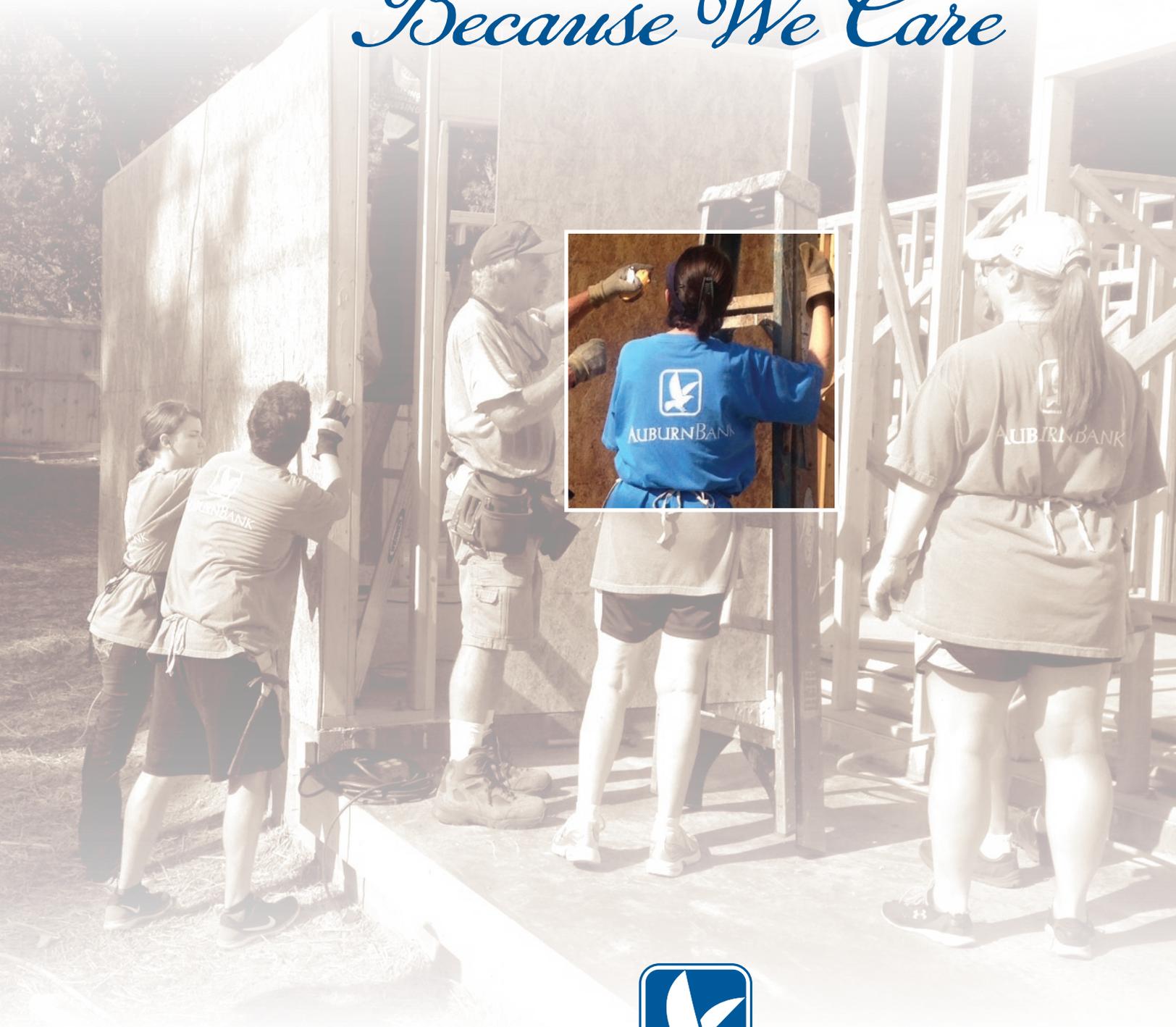


# *Because We Care*



AUBURN NATIONAL BANCORPORATION, INC.

2016 ANNUAL REPORT



*Because We Care*

AUBURN NATIONAL BANCORPORATION, INC.

2016 ANNUAL REPORT



**AUBURN BANK**

SINCE 1907

YOUR PARTNER, YOUR NEIGHBOR,  
YOUR FRIEND



# TO OUR SHAREHOLDERS AND FRIENDS

Our last fiscal year set new standards for our bank. We closed the year with record size and profit. Assets of \$832 million and net earnings of \$8.2 million were both high for AuburnBank and they were a reflection of the quality of our efforts and the talent and dedication of our staff.

More and more citizens of East Alabama are learning what it means when we say “may I help you.” And it is obvious to those who are in a position to know that this is a distinct trait of AuburnBank. Our number one job is to take care of your money and that is what we do. But we also care and we serve. Many of the stories employees shared revealed what we were asked to do, and what we did.

Thank you for allowing us to conduct this necessary service for you. It is what we do and we thank you for the opportunity.

A handwritten signature in black ink, appearing to read "E.L. Spencer, Jr.", with a stylized flourish at the end.

E.L. Spencer, Jr.  
Chairman, Board of Directors  
AuburnBank and ANBC

# CORPORATE PROFILE

2016 results for AuburnBank were very strong. Record earnings of \$8.2 million were achieved through early retirement of long-term debt at a discount, a sizeable recovery thus positively affecting our contributions to our allowance for loan and lease losses, continued growth in our loan portfolio coupled with top asset quality and efficient management.

These record results reflect not only good management planning and implementation of sound banking fundamentals but are also directly related to our founding principle—“Because We Care.”

For 110 years our caring commitment to our customers, and to the communities we serve has been based on a caring philosophy. In the following pages of our annual report you will hear from several members of the AuburnBank Team as to their feelings about how caring creates a successful organization. Meeting customers financial needs on a daily basis along with serving many in our community who are in need of basic necessities creates a positive organization that has grown and made a significant impact for 110 years. I believe “Because We Care” is an underlying foundation that will continue to assist our bank in being your partner, neighbor and friend.

Thank you for your loyal support and we look forward to many more years of service.



Robert W. Dumas  
President and CEO  
AuburnBank



*Because*



# We Care

The fifth grader ran from AuburnBank employee to employee, taking pictures of each face. “Smile! I want to remember the best day of my life,” she told them.

The day consisted of a ground-breaking ceremony for a local family and their new home, courtesy of Habitat for Humanity and local volunteers.

“I couldn’t help but cry at her enthusiasm,” says Suzanne Gibson, AuburnBank’s CRA supervisor, tearing up at the memory. “Her little face is the reason AuburnBank does what it does.”

And what it does is care. Since 1907, AuburnBank has maintained a culture of community and service. Customers are viewed as people, not transactions.

“Each customer has a story to tell, and within those stories, we find ways to help others,” says Bernice Jackson, a 16-year employee who now supervises teller operations.

The company has a strong presence in local charitable organizations such as Habitat for Humanity, United Way and Food Bank of East Alabama, to name a few.

“AuburnBank employees volunteered this past year to work on and complete a Habitat for Humanity home in Auburn. They are involved in the planning of a home in Opelika which will be built in 2017,” says Mark Grantham of Habitat for Humanity.

Martha Henk of the East Alabama Food Bank echoes the gratitude. “When the Community Market (an extension of the East Alabama Food Bank) opened its doors in January 2003, AuburnBank pledged quarterly support which faithfully continues today,” says Henk. “When one in five of our East/Central Alabama neighbors experiences food insecurity, the Community Market strives to feed as many neighbors as we can. None of this would be possible without community support, and AuburnBank is a shining example of making a difference in the community.”

DAVID  
WARREN



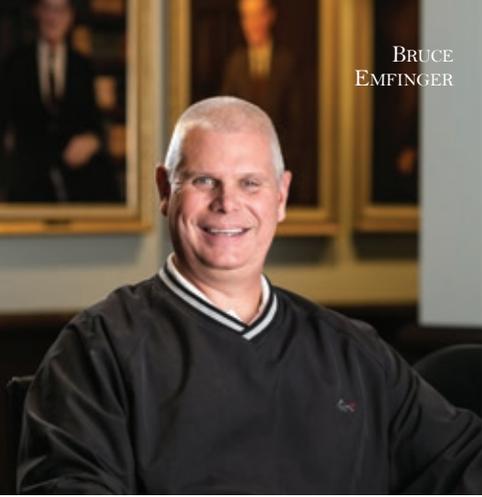
MARCIA  
OTWELL



JAMES  
SALTER



BRUCE  
EMFINGER



AuburnBank has been involved with LifeSouth Community Blood Centers since 2006 by hosting blood drives. Since the first one, the bank has donated more than 600 units for local hospitals. “AuburnBank donors are true community heroes,” says Heather McDonald, donor recruiter for LifeSouth. The organization supplies 100 percent of blood products to East Alabama Medical Center.

On any given day, on any chosen field, you can find an AuburnBank team mom, coach or concession worker. Open the paper to find a local concern, and you’ll see an AuburnBank employee. “We’re visible in all communities,” says Jim Pack who heads up the bank’s SEC reporting. “Very engaged in not just the big projects, but the smaller concerns too.” Pack referred to Randi Hurley’s branch in Notasulga, who raised money after a family’s house burned, and the bank replaced one of the children’s glasses.

BERNICE  
JACKSON



“WHEN ONE IN FIVE OF OUR EAST/CENTRAL ALABAMA NEIGHBORS EXPERIENCES FOOD INSECURITY, THE COMMUNITY MARKET STRIVES TO FEED AS MANY NEIGHBORS AS WE CAN. NONE OF THIS WOULD BE POSSIBLE WITHOUT COMMUNITY SUPPORT, AND AUBURNBANK IS A SHINING EXAMPLE OF MAKING A DIFFERENCE IN THE COMMUNITY.”

Martha Henk of the East Alabama Food Bank

BROOKS  
CRAWFORD



Although the bank has no formal volunteer requirement, employees with a servant’s heart find their way to AuburnBank. “Our team has a desire to serve and to be of service,” says Eddie Smith, city president of Opelika. Smith was instrumental in raising significant funds for the Miracle League Field in Opelika to serve the athletic desires of people with disabilities. Smith also notes the teamwork within the company itself which allows him and others to serve the community. “I know I can call Brooks Crawford in our loan operations, and he will own the problem. I don’t have to give it a second thought. His service to me is what allows me to serve others.”

JIM  
PACK





“AUBURNBANK EMPLOYEES VOLUNTEERED THIS PAST YEAR TO WORK ON AND COMPLETE A HABITAT FOR HUMANITY HOME IN AUBURN. THEY ARE INVOLVED IN THE PLANNING OF A HOME IN OPELIKA WHICH WILL BE BUILT IN 2017.” Mark Grantham of Habitat for Humanity

Bruce Emfinger, commercial lender in Valley, says AuburnBank employees don't think in terms of 8 to 5. “There are 24 hours in a day. Our job is to bring the bank to the customer. Sometimes that can be a ballfield, sometimes that is an aisle in the grocery store. You never trade one hat for another,” says Emfinger.

Commercial Lender David Warren says the type of people who work at AuburnBank is a testament to upper management. He notes the relationship aspect of banking. “Our job is to create relationships either through loans and deposits or through church or children's activities. We should never be known as a banker, but as a member of the community who serves others. We simply enjoy helping other people. We have a rich history in this regard of which our current management nurtures and grows.”

The blessings returned for the bank's involvement far outweigh the volunteer efforts. The Habitat for Humanity team witnessed a little girl who cried the day her family received the keys to her new home. “She moved a mattress into her bubble gum pink room, the color she picked out. She was determined to sleep in her house the first night,” says Marcia Otwell who has worked with AuburnBank for 30 years.

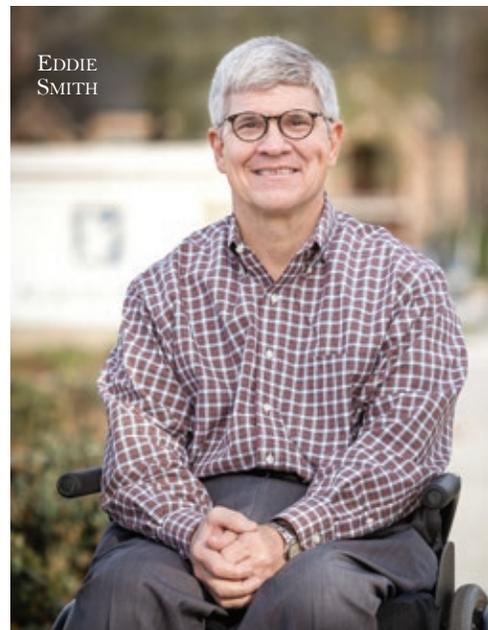
The best day of the fifth grader's life turned out to be a precursor to an even better day down the road thanks to the caring hearts of AuburnBank employees. From food banks to football, bank accounts to ballet, AuburnBank employees wake each day with a desire to serve others.

The original founders of AuburnBank would be proud of the continued legacy of caring that began in 1907. The impact on the communities we serve and on the entire AuburnBank Team is reflected in the growth of our communities and the success AuburnBank has achieved. Thank you to our many customers and shareholders who make these contributions and achievements possible.

RANDI HURLEY



EDDIE SMITH



SUZANNE GIBSON



# Auburn National Bancorporation, Inc. and AuburnBank Board of Directors



Seated left to right: Robert W. Dumas, Anne M. May, E.L. Spencer, Jr., David E. Housel, William F. Ham, Jr.  
Standing: Dr. Patricia Wade, C. Wayne Alderman, Edward Lee Spencer, III,  
Terry W. Andrus, Amy B. Murphy, and J. Tutt Barrett.

Terry W. Andrus  
President, East Alabama  
Medical Center

C. Wayne Alderman  
Secretary to ANBC  
Dean of Enrollment Services and  
former Dean,  
College of Business,  
Auburn University

J. Tutt Barrett  
Attorney, Dean and Barrett

Robert W. Dumas  
President & CEO, AuburnBank

William F. Ham, Jr.  
Mayor, City of Auburn  
& Owner, Varsity Enterprises

David E. Housel  
Director of Athletics Emeritus,  
Auburn University

Anne M. May  
Partner, Machen, McChesney  
& Chastain, CPAs

Amy B. Murphy  
Director of Graduate Programs,  
Accounting,  
Auburn University

E.L. Spencer, Jr.  
Chairman, AuburnBank  
and ANBC, Business Owner

Edward Lee Spencer, III  
Investor

Dr. Patricia Wade  
Physician,  
Auburn Cardiovascular

## AuburnBank Officers

E.L. Spencer, Jr.  
Chairman

Robert W. Dumas  
President & Chief  
Executive Officer

Terrell E. Bishop  
Senior Vice President,  
City President, Valley Branch

James E. Dulaney  
Senior Vice President,  
Business Development/Marketing

David Hedges  
Executive Vice President,  
Chief Financial Officer

W. Thomas Johnson  
Senior Vice President,  
Senior Lender

Marla Kickliter  
Senior Vice President,  
Compliance/Internal Auditor

Shannon O'Donnell  
Senior Vice President,  
Credit Administration/Chief  
Risk Officer

Jerry Siegel  
Senior Vice President, IT/IS  
Chief Technology Officer

C. Eddie Smith  
Senior Vice President,  
City President,  
Opelika Branch

Robert Smith  
Senior Vice President,  
Chief Lending Officer

James Walker  
Senior Vice President,  
Chief Accounting Officer

Bob R. Adkins  
Vice President,  
Commercial/Consumer  
Loans

Patty Allen  
Vice President,  
Commercial/Consumer  
Loans

Scottie Arnold  
Vice President,  
Operations/Patriot  
Act Officer

Kris Blackmon  
Vice President,  
Asset/Liability Manager  
Chief Investment Officer

S. Mark Bridges  
Senior Vice President,  
Commercial/Consumer  
Loans

Laura Carrington  
Vice President,  
Human Resource Officer

Kathy Crawford  
Vice President,  
Commercial/Consumer  
Loans

Bruce Emfinger  
Vice President,  
Commercial/Consumer  
Loans

Jeff Stanfield  
Vice President,  
Commercial/Consumer  
Loans

James Salter  
Vice President,  
Commercial/Consumer  
Loans

Christy A. Fogle  
Vice President,  
Credit Administration

Pam Fuller  
Vice President,  
Operations

Ginnie Y. Lunsford  
Vice President,  
Loan Operations

Marcia Otwell  
Vice President,  
Administration/Shareholder  
Relations

James R. Pack  
Vice President,  
Financial Reporting

Cyndee Redmond  
Vice President, Treasury  
Management and Electronic  
Services

David Warren  
Vice President,  
Commercial/Consumer Loans

Karen Bence  
Assistant Vice President  
Security, BSA/OFAC Officer

Hope Woods  
Assistant BSA Officer,  
Assistant Security Officer

Suzanne Gibson  
Assistant Vice President,  
Portfolio Management Officer

Woody Odom  
Assistant Vice President, IT/IS

Joanna Watts  
IT/IS Officer

Rhonda Sanders  
Customer Service  
Officer/Assistant Patriot  
Act Officer

Leigh Ann Thompson  
Branch Operations  
Administrative Officer

## Opelika Branch Advisory Board



Seated left to right: C. Eddie Smith, Sherrie M. Stanyard, and Doug M. Horn.  
Standing: William G. Dyas, William P. Johnston,  
Robert G. Young, and William H. Brown.  
Not pictured: R. Kraig Smith, M.D.

William H. Brown  
President, Brown Agency, Inc.

William G. Dyas  
Realtor, First Realty

Doug M. Horn  
Owner, Doug Horn Roofing  
& Contracting Co.

William P. Johnston  
President, J & M Bookstore

C. Eddie Smith  
Senior Vice President,  
City President,  
Opelika Branch

R. Kraig Smith, M.D.  
Lee OBGYN

Sherrie Murphy Stanyard  
Senior Account Manager,  
Craftmaster Printers, Inc.

Robert G. Young  
Vice President, Sales  
Young's Plant Farm, Inc.

## Valley Branch Advisory Board



Left to right: H. David Ennis, Sr., Roy W. McClendon, Jr.,  
Terrell E. Bishop, Frank P. Norman, and John H. Hood, II.  
Not pictured: Claud E. (Skip) McCoy, Jr.

Terrell E. Bishop  
Senior Vice President,  
City President, Valley Branch

H. David Ennis, Sr.  
President, Novelli-Ennis &  
Company, CPAs

John H. Hood, II  
Pharmacist, Hood's Pharmacy

Roy W. McClendon, Jr.  
Retired Pharmacist

Claud E. (Skip) McCoy, Jr.  
Attorney, Johnson, Caldwell  
& McCoy Law Firm

Frank P. Norman  
Owner, Johnny's New York Style  
Pizza and WingStop

# Auburn National Bancorporation, Inc.

## Financial Highlights

(Dollars in thousands, except per share data)

	For the Years Ended December 31,				
	2016	2015	2014	2013	2012
<b>Earnings</b>					
Net Interest Income	\$22,732	\$22,718	\$21,453	\$20,922	\$20,897
Provision for Loan Losses	<485>	200	50	400	3,815
Net Earnings	8,150	7,858	7,448	7,118	6,763
Per Share:					
Net Earnings	2.24	2.16	2.04	1.95	1.86
Cash Dividends	0.90	0.88	0.86	0.84	0.82
Book Value	22.55	21.94	20.80	17.70	19.26
Shares Issued	3,957,135	3,957,135	3,957,135	3,957,135	3,957,135
Weighted Average Shares Outstanding	3,643,504	3,643,428	3,643,278	3,643,003	3,642,831
<b>Financial Condition</b>					
Total Assets	831,943	817,189	789,231	751,343	759,833
Loans, net of unearned income	430,946	426,410	402,954	383,339	398,193
Investment Securities	243,572	241,687	267,603	271,219	259,475
Total Deposits	739,143	723,627	693,390	668,844	636,817
Long Term Debt	3,217	7,217	12,217	12,217	47,217
Stockholders' Equity	82,177	79,949	75,799	64,485	70,149
<b>Selected Ratios</b>					
Return on Average Total Assets	0.98%	0.98%	0.97%	0.94%	0.90%
Return on Average Total Equity	9.65%	9.98%	10.53%	10.33%	9.85%
Average Stockholders' Equity to Average Assets	10.14%	9.79%	9.17%	9.07%	9.09%
Allowance for Loan Losses as a % of Loans	1.08%	1.01%	1.20%	1.37%	1.69%
Loans to Total Deposits	58.30%	58.93%	58.11%	57.31%	62.53%



**AUBURN BANK**

SINCE 1907  
YOUR PARTNER. YOUR NEIGHBOR.  
YOUR FRIEND

**Financial Section**

Auburn National Bancorporation, Inc. 2016 Annual Report

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**SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Various of the statements made herein under the captions “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, “Quantitative and Qualitative Disclosures about Market Risk”, “Risk Factors” and elsewhere, are “forward-looking statements” within the meaning and protections of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause the actual results, performance, achievements or financial condition of the Company to be materially different from future results, performance, achievements or financial condition expressed or implied by such forward-looking statements. You should not expect us to update any forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as “may,” “will,” “anticipate,” “assume,” “should,” “indicate,” “would,” “believe,” “contemplate,” “expect,” “estimate,” “continue,” “plan,” “point to,” “project,” “could,” “intend,” “target” and other similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation, (i) the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality; (ii) governmental monetary and fiscal policies; (iii) legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance; (iv) changes in accounting policies, rules and practices; (v) the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable; (vi) changes in borrower credit risks and payment behaviors; (vii) changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes; (viii) changes in the prices, values and sales volumes of residential and commercial real estate; (ix) the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services; (x) the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates; (xi) the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions; (xii) changes in technology or products that may be more difficult, costly, or less effective than anticipated; (xiii) the effects of war or other conflicts, acts of terrorism or other catastrophic events that may affect general economic conditions; (xiv) cyber-attacks and data breaches that may compromise our systems or customers’ information; (xv) the failure of assumptions and estimates, as well as differences in, and changes to, economic, market and credit conditions, including changes in borrowers’ credit risks and payment behaviors from those used in our loan portfolio stress tests; (xvi) the risks that our deferred tax assets could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards that we may be able to utilize for income tax purposes; and (xvii) other factors and risks described under “Risk Factors” herein and in any of our subsequent reports that we make with the Securities and Exchange Commission (the “Commission” or “SEC”) under the Exchange Act.

All written or oral forward-looking statements that are made by us or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

## BUSINESS INFORMATION

Auburn National Bancorporation, Inc. (the “Company”) is a bank holding company registered with the Board of Governors of the Federal Reserve System (the “Federal Reserve”) under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Company was incorporated in Delaware in 1990, and in 1994 it succeeded its Alabama predecessor as the bank holding company controlling AuburnBank, an Alabama state member bank with its principal office in Auburn, Alabama (the “Bank”). The Company and its predecessor have controlled the Bank since 1984. As a bank holding company, the Company may diversify into a broader range of financial services and other business activities than currently are permitted to the Bank under applicable laws and regulations. The holding company structure also provides greater financial and operating flexibility than is presently permitted to the Bank.

The Bank has operated continuously since 1907 and currently conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank has been a member of the Federal Reserve System since April 1995. The Bank’s primary regulators are the Federal Reserve and the Alabama Superintendent of Banks (the “Alabama Superintendent”). The Bank has been a member of the Federal Home Loan Bank of Atlanta (the “FHLB”) since 1991.

### Services

The Bank offers checking, savings, transaction deposit accounts and certificates of deposit, and is an active residential mortgage lender in its primary service area. The Bank’s primary service area includes the cities of Auburn and Opelika, Alabama and nearby surrounding areas in East Alabama, primarily in Lee County. The Bank also offers commercial, financial, agricultural, real estate construction and consumer loan products and other financial services. The Bank is one of the largest providers of automated teller services in East Alabama and operates ATM machines in 14 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank’s Visa Checkcards can be used internationally through the Plus® network. The Bank offers online banking, bill payment and other electronic services through its Internet website, [www.auburnbank.com](http://www.auburnbank.com)

The Bank also has a commercial loan production office in Phenix City, Alabama.

### Loans and Loan Concentrations

The Bank makes loans for commercial, financial and agricultural purposes, as well as for real estate mortgages, real estate acquisition, construction and development and consumer purposes. While there are certain risks unique to each type of lending, management believes that there is more risk associated with commercial, real estate acquisition, construction and development, agricultural and consumer lending than with residential real estate mortgage loans. To help manage these risks, the Bank has established underwriting standards used in evaluating each extension of credit on an individual basis, which are substantially similar for each type of loan. These standards include a review of the economic conditions affecting the borrower, the borrower’s financial strength and capacity to repay the debt, the underlying collateral and the borrower’s past credit performance. We apply these standards at the time a loan is made and monitor them periodically throughout the life of the loan. See “Lending Practices” for a discussion of regulatory guidance on commercial real estate lending.

The Bank has loans outstanding to borrowers in all industries within its primary service area. Any adverse economic or other conditions affecting these industries would also likely have an adverse effect on the local workforce, other local businesses, and individuals in the community that have entered into loans with the Bank. For example, the auto manufacturing business and its suppliers have positively affected our local economy, but automobile manufacturing is cyclical and adversely affected by increases in interest rates. Decreases in automobile sales, including adverse changes due to interest rate increases, could adversely affect nearby Kia and Hyundai automotive plants and their suppliers’ local spending and employment, and could adversely affect economic conditions in the markets we serve. However, management believes that due to the diversified mix of industries located within the Bank’s primary service area, adverse changes in one industry may not necessarily affect other area industries to the same degree or within the same time frame. The Bank’s primary service area also is subject to both local and national economic conditions and fluctuations. While most loans are made within our primary service area, some residential mortgage loans are originated outside the primary service area, and the Bank from time to time has purchased loan participations from outside its primary service area.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition at December 31, 2016 and 2015 and our results of operations for the years ended December 31, 2016 and 2015. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, "Risk Factors" and "Special Cautionary Notice Regarding Forward-Looking Statements".

### OVERVIEW

The Company was incorporated in 1990 under the laws of the State of Delaware and became a bank holding company after it acquired its Alabama predecessor, which was a bank holding company established in 1984. The Bank, the Company's principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Notasulga and Valley, Alabama. In-store branches are located in the Kroger and Wal-Mart SuperCenter stores in Opelika. The Bank also operates a commercial loan production office in Phenix City, Alabama.

### Summary of Results of Operations

	Year ended December 31	
	2016	2015
<i>(Dollars in thousands, except per share data)</i>		
Net interest income (a)	\$ 24,008	\$ 24,060
Less: tax-equivalent adjustment	1,276	1,342
Net interest income (GAAP)	22,732	22,718
Noninterest income	3,383	4,532
Total revenue	26,115	27,250
Provision for loan losses	(485)	200
Noninterest expense	15,348	16,372
Income tax expense	3,102	2,820
Net earnings	\$ 8,150	\$ 7,858
Basic and diluted earnings per share	\$ 2.24	\$ 2.16

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

### Financial Summary

The Company's net earnings were \$8.2 million, or \$2.24 per share, for the full year 2016, compared to \$7.9 million, or \$2.16 per share, for the full year 2015.

Net interest income (tax-equivalent) was \$24.0 million in 2016, compared to \$24.1 million in 2015. Net interest income (tax-equivalent) in 2015 included \$0.2 million in recoveries of interest related to payoffs received on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) increased slightly in 2016 compared to 2015. Management continues to seek to increase earnings by growing the Company's loan portfolio (in total and as a percentage of our earning assets), focusing on deposit pricing, and repaying higher-cost wholesale funding sources. These efforts to increase earnings were offset by declining yields in the securities portfolio due to maturities and calls and management's decision to carry higher levels of short-term interest earning assets such as deposits at other banks. Average loans were \$430.8 million in 2016, an increase of \$19.4 million or 5%, from 2015. Average deposits were \$734.7 million in 2016, an increase of \$24.4 million or 3%, from 2015.

The Company recorded a negative provision for loan losses of \$0.5 million for 2016, compared to a charge of \$0.2 million for 2015. Net recoveries as a percent of average loans were 0.19% for 2016 compared to net charge-offs as a percent of average loans of 0.18% for 2015. The Company recognized a recovery of \$1.2 million from the payoff of one nonperforming construction and land development loan during 2016. Excluding this recovery, net charge-offs as a percent of average loans would have been 0.08% in 2016.

---

Noninterest income was \$3.4 million in 2016, compared to \$4.5 million in 2015. The decrease was primarily due to \$0.3 million in non-taxable death benefits from bank-owned life insurance that were received in 2015, compared to none in 2016; a decrease in mortgage lending income of \$0.5 million as mortgage loan production declined; and \$0.2 million in securities losses, net during 2016 compared to securities gains, net of \$16 thousand in 2015.

Noninterest expense was \$15.3 million in 2016, compared to \$16.4 million in 2015. The decrease was primarily due to a gain on early extinguishment of debt of \$0.8 million in 2016 compared to a \$0.4 million loss on early extinguishment of debt in 2015. The Company purchased \$4.0 million of trust preferred securities related to its junior subordinated debentures with a floating rate of 3.63% in 2016 and repaid \$5.0 million of fixed-rate long-term debt with an interest rate of 3.59% in 2015. In addition, other real estate owned expense decreased \$0.4 million primarily due to realized holding gains on the sale of OREO. These decreases were partially offset by a \$0.5 million increase in salaries and benefits due to routine annual increases.

Income tax expense was \$3.1 million in 2016 compared to \$2.8 million in 2015. The Company's effective income tax rate was 27.57% in 2016, compared to 26.41% in 2015. The increase in the effective tax rate was primarily attributable to an increase in the level of earnings before taxes and a decrease in tax exempt earnings from bank-owned life insurance. The Company's effective income tax rate is principally impacted by tax-exempt earnings from the Company's investments in municipal securities and bank-owned life insurance.

In 2016, the Company paid cash dividends of \$3.3 million, or \$0.90 per share. The Company remains "well capitalized" under current regulatory guidelines with a total risk-based capital ratio of 17.95%, a Tier 1 risk-based capital ratio of 17.00%, a Tier 1 leverage capital ratio of 10.27% and a Common Equity Tier 1 ("CET1") capital ratio of 16.44% at December 31, 2016.

## **CRITICAL ACCOUNTING POLICIES**

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, the valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

### **Allowance for Loan Losses**

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a "confirming event" has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal, independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company's loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2016 and 2015, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several "qualitative and environmental" factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. Beginning with the quarter ended December 31, 2016, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. First, the Company increased its look-back period for calculating average losses for all loan segments to 31 quarters. Prior to December 31, 2016, the Company calculated average losses for all loan segments using a rolling 20 quarter look-back period. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. Second, the Company increased the range of basis point adjustments allowed for qualitative and environmental factors to approximately 200 basis points, an increase of 65 basis points, or 48%, compared to the 135 basis point range used prior to December 31, 2016. After performing sensitivity testing of its calculation of the allowance for loan losses, the Company determined that it should increase the range of basis points allowed for qualitative and environmental factors in order to provide sufficient latitude in determining estimated probable credit losses during periods of economic stress. Third, the Company reduced the percentage allocation for qualitative and environmental factors on a weighted average basis to 21% of total basis points allocable at December 31, 2016, compared to 25% of total basis points allocable at September 30, 2016. The Company believes a decrease in the percentage allocation of qualitative environmental factors on a weighted average basis was appropriate due to the extension of its look-back period described above. If the Company did not make the changes described above, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$0.9 million, or 0.21% of total loans, at December 31, 2016. Other than the changes discussed above, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

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## Assessment for Other-Than-Temporary Impairment of Securities

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities for which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

## Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company's assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 17, Fair Value, of the consolidated financial statements that accompany this report.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company's assets or liabilities lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management's best estimates for appropriate discount rates, default rates, prepayments, market volatility and other factors, taking into account current observable market data and experience.

These assumptions may have a significant effect on the reported fair values of assets and liabilities and the related income and expense. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

## Other Real Estate Owned

Other real estate owned ("OREO"), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal of OREO are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other OREO.

## Deferred Tax Asset Valuation

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2016. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

## Average Balance Sheet and Interest Rates

	Year ended December 31			
	2016		2015	
	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
<i>(Dollars in thousands)</i>				
Loans and loans held for sale	\$ 432,180	4.73%	\$ 413,616	4.95%
Securities - taxable	166,870	1.97%	186,845	2.06%
Securities - tax-exempt (a)	68,507	5.48%	68,386	5.77%
Total securities	235,377	2.99%	255,231	3.05%
Federal funds sold	49,446	0.50%	58,607	0.23%
Interest bearing bank deposits	70,064	0.51%	31,028	0.25%
Total interest-earning assets	787,067	3.57%	758,482	3.76%
Deposits:				
NOW	121,723	0.27%	115,146	0.30%
Savings and money market	232,601	0.38%	215,936	0.39%
Certificates of deposits less than \$100,000	80,760	0.97%	91,136	1.03%
Certificates of deposits and other time deposits of \$100,000 or more	131,902	1.39%	140,831	1.43%
Total interest-bearing deposits	566,986	0.68%	563,049	0.73%
Short-term borrowings	2,973	0.50%	3,601	0.50%
Long-term debt	6,474	3.52%	8,286	3.40%
Total interest-bearing liabilities	576,433	0.71%	574,936	0.77%
Net interest income and margin (a)	\$ 24,008	3.05%	\$ 24,060	3.17%

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

## RESULTS OF OPERATIONS

### Net Interest Income and Margin

Net interest income (tax-equivalent) was \$24.0 million in 2016, compared to \$24.1 million in 2015. Net interest income (tax-equivalent) for 2015 included \$0.2 million in recoveries of interest related to payoffs recorded on two loans that were previously impaired. Excluding the impact of these interest recoveries, net interest income (tax-equivalent) would have increased slightly in 2016 compared to 2015. Management continues to seek to increase earnings by growing the Company's loan portfolio (in total and as a percentage of our earning assets), focusing on deposit pricing, and repaying higher-cost wholesale funding sources. These efforts to increase earnings were offset by declining yields in the securities portfolio due to maturities and calls and management's decision to carry higher levels of short-term interest earning assets such as deposits at other banks.

The tax-equivalent yield on total interest-earning assets decreased by 19 basis points in 2016 from 2015 to 3.57%. The decrease was primarily due to increased pricing competition for quality loan opportunities in our markets, which has limited the Company's ability to increase the yields on new and renewed loans; and declining yields on securities due to maturities and calls.

The cost of total interest-bearing liabilities decreased 6 basis points in 2016 from 2015 to 0.71%. The net decrease was largely the result of the continued shift in our funding mix, as we increased our lower-cost interest-bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposits and long-term debt.

The Company continues to deploy various asset liability management strategies to manage its risk to interest rate fluctuations. The Company's net interest margin could experience pressure due to lower reinvestment yields in the securities portfolio given the current interest rate environment, increased pricing competition for quality loan opportunities, and fewer opportunities to further reduce our cost of funds due to the low level of deposit rates currently.

### Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The Company recorded a negative provision for loan losses of \$0.5 million for the year ended December 31, 2016 compared to a charge of \$0.2 million for the year ended December 31 2015. The decrease in provision expense was primarily due to an increase in net recoveries.

Net recoveries were \$0.8 million, or 0.19% of average loans and net charge-offs were \$0.7 million, or 0.18% of average loans, for the years ended December 31, 2016 and 2015, respectively. The Company recognized a recovery of \$1.2 million from the payoff of one nonperforming construction and land development loan during 2016. Excluding this recovery, net charge-offs as a percent of average loans would have been 0.08% in 2016.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes to be appropriate to adequately cover probable losses in the loan portfolio. The Company's allowance for loan losses to total loans increased to 1.08% at December 31, 2016 from 1.01% at December 31, 2015. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2016. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are believed adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgment and are therefore approximate and imprecise. Factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions exist which may negatively and materially affect our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

### Noninterest Income

<i>(Dollars in thousands)</i>	Year ended December 31	
	2016	2015
Service charges on deposit accounts	\$ 773	\$ 823
Mortgage lending	947	1,444
Bank-owned life insurance	456	747
Securities (losses) gains, net	(221)	16
Other	1,428	1,502
<b>Total noninterest income</b>	<b>\$ 3,383</b>	<b>\$ 4,532</b>

Service charges on deposit accounts decreased primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

The Company's income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing of mortgage loans. Origination income, net, is comprised of gains or losses from the sale of the mortgage loans originated, origination fees, underwriting fees and other fees associated with the origination of loans, which are netted against the commission expense associated with these originations. The Company's normal practice is to originate mortgage loans for sale in the secondary market and to either sell or retain the associated mortgage servicing rights ("MSRs") when the loan is sold.

MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Servicing fee income is reported net of any related amortization expense.

The Company evaluates MSR for impairment on a quarterly basis. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group's aggregate fair value, a valuation allowance for that group is established. The valuation allowance is adjusted as the fair value changes. An increase in mortgage interest rates typically results in an increase in the fair value of the MSRs while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSRs.

The following table presents a breakdown of the Company's mortgage lending income for 2016 and 2015.

<i>(Dollars in thousands)</i>	Year ended December 31	
	2016	2015
Origination income	\$ 764	\$ 1,152
Servicing fees, net	184	239
(Increase) decrease in MSR valuation allowance	(1)	53
<b>Total mortgage lending income</b>	<b>\$ 947</b>	<b>\$ 1,444</b>

The decrease in mortgage lending income was primarily due to a decrease in the volume of mortgage loans originated and sold. The decrease in volume is due to various factors, including the Company's efforts to comply with the new TILA-RESPA Integrated Disclosure (TRID) rules and a reduction in the number of mortgage originators. Servicing fees, net decreased as amortization expense increased due to faster prepayments.

Income from bank-owned life insurance decreased in 2016, compared to 2015 due to non-taxable death benefits received in the prior year. The assets that support these policies are administered by the life insurance carriers and the income we receive (i.e. increases or decreases in the cash surrender value of the policies) on these policies is dependent upon the returns the insurance carriers are able to earn on the underlying investments that support these policies. Earnings on these policies are generally not taxable.

Securities (losses) gains, net consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net losses realized on the sale of securities were \$221 thousand for 2016, compared to net gains realized on the sale of securities of \$16 thousand for 2015. The Company did not incur any other-than-temporary impairment charges in 2016 and 2015.

### Noninterest Expense

<i>(Dollars in thousands)</i>	Year ended December 31	
	2016	2015
Salaries and benefits	\$ 9,826	\$ 9,293
Net occupancy and equipment	1,474	1,547
Professional fees	825	756
FDIC and other regulatory assessments	406	472
Other real estate owned, net	(371)	11
(Gain) loss on early extinguishment of debt	(790)	362
Other	3,978	3,931
<b>Total noninterest expense</b>	<b>\$ 15,348</b>	<b>\$ 16,372</b>

The increase in salaries and benefits expense reflects routine annual increases.

The decrease in FDIC and other regulatory assessments expense was primarily due to a decrease in the Bank's initial assessment rate during 2016. In addition to changes in the FDIC assessment rate formula for banks with less than \$10 billion in assets, the initial assessment rate for all banks decreased effective July 1, 2016 due to the Deposit Insurance Reserve Fund ratio exceeding 1.15% at June 30, 2016.

The decrease in other real estate owned expense was primarily due to gains realized from sale of OREO.

During 2016 the Company recognized a \$0.8 million gain on early extinguishment of debt when it purchased \$4.0 million of the \$7.0 million in outstanding trust preferred securities issued by Auburn National Bancorporation Capital Trust, Inc. (the "Trust") and deemed an equivalent amount of the related junior subordinated debentures issued by the Company as no longer outstanding. During 2015, the Company repaid \$5.0 million of long-term debt with an interest rate of 3.59% and incurred \$0.4 million loss on early extinguishment of debt.

## Income Tax Expense

Income tax expense was \$3.1 million in 2016 compared to \$2.8 million in 2015. The Company's effective income tax rate was 27.57% in 2016, compared to 26.41% in 2015. The Company's effective income tax rate increased primarily due to an increase in the levels of earnings before taxes and a decrease in tax exempt earnings from bank-owned life insurance.

## BALANCE SHEET ANALYSIS

### Securities

Securities available-for-sale were \$243.6 million at December 31, 2016, an increase of \$1.9 million, or 1%, compared to \$241.7 million as of December 31, 2015. This increase was primarily due to an increase of \$6.1 million in amortized cost basis of securities available-for-sale from purchases, net of principal repayments, maturities and calls, partially offset by a decrease of \$4.2 million due to the change in unrealized gains (losses) on available-for-sale securities, reflecting a decrease in prices as long-term interest rates increased. The average tax-equivalent yields earned on total securities were 2.99% in 2016 and 3.05% in 2015.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2016 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities ("RMBS") because the mortgages underlying the securities may be called or prepaid with or without penalty.

<i>(Dollars in thousands)</i>	December 31, 2016				
	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Total Fair Value
Agency obligations	\$ 3,047	22,531	19,893	—	45,471
Agency RMBS	—	972	16,171	110,644	127,787
State and political subdivisions	—	2,480	10,210	57,624	70,314
Total available-for-sale	\$ 3,047	25,983	46,274	168,268	243,572
<b>Weighted average yield:</b>					
Agency obligations	1.01%	1.82%	1.95%	—	1.82%
Agency RMBS	—	2.24%	2.32%	2.23%	2.24%
State and political subdivisions	—	3.95%	3.83%	3.28%	3.38%
Total available-for-sale	1.01%	2.04%	2.49%	2.59%	2.49%

### Loans

<i>(In thousands)</i>	December 31				
	2016	2015	2014	2013	2012
Commercial and industrial	\$ 49,850	52,479	54,329	57,780	59,334
Construction and land development	41,650	43,694	37,298	36,479	37,631
Commercial real estate	220,439	203,853	192,006	174,920	183,611
Residential real estate	110,855	116,673	107,641	101,706	105,631
Consumer installment	8,712	10,220	12,335	12,893	12,219
Total loans	431,506	426,919	403,609	383,778	398,426
Less: unearned income	(560)	(509)	(655)	(439)	(233)
Loans, net of unearned income	\$ 430,946	426,410	402,954	383,339	398,193

Total loans, net of unearned income, were \$430.9 million at December 31, 2016, an increase of \$4.5 million, or 1%, from \$426.4 million at December 31, 2015. Four loan categories represented the majority of the loan portfolio at December 31, 2016: commercial real estate mortgage loans (51%), residential real estate mortgage loans (26%), commercial and industrial loans (12%) and construction and land development loans (10%). Approximately 23% of the Company's commercial real estate loans were classified as owner-occupied at December 31, 2016 and 2015.

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately \$13.7 million, or 3%, and \$16.4 million, or 4%, of total loans, net of unearned income at December 31, 2016 and 2015, respectively. For residential real estate mortgage loans with a consumer purpose, approximately \$1.4 million and \$0.9 million required interest-only payments at December 31, 2016 and 2015, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately \$1.3 million and \$1.4 million as of December 31, 2016 and 2015, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described under "Critical Accounting Policies – Allowance for Loan Losses".

The average yield earned on loans and loans held for sale was 4.73% in 2016 and 4.95% in 2015.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the effects of current economic conditions on our borrowers' cash flows, real estate market sales volumes, valuations, and availability and cost of financing for properties, real estate industry concentrations, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of applicable laws and regulations.

The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers' financial positions. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit a bank's credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital accounts; or 20% of capital accounts, if loans in excess of 10% are fully secured. Under these regulations, we are prohibited from having secured loan relationships in excess of approximately \$17.8 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$16.0 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2016, the Bank had no loan relationships exceeding this limit.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank's total risk-based capital at December 31, 2016 (and related balances at December 31, 2015).

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
Multi-family residential properties	\$ 46,998	\$ 45,264
Lessors of 1-4 family residential properties	45,290	46,664
Shopping centers	40,925	38,116
Office buildings	22,366	18,818

**Allowance for Loan Losses**

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company's estimate of probable losses in the loan portfolio. As of December 31, 2016 and 2015, respectively, the allowance for loan losses was \$4.6 million and \$4.3 million, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under "Critical Accounting Policies".

A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2016 is presented below.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>				
	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 4,289	4,836	5,268	6,723	6,919
Charge-offs:					
Commercial and industrial	(97)	(100)	(46)	(514)	(289)
Construction and land development	—	—	(235)	(39)	(231)
Commercial real estate	(194)	(866)	—	(262)	(3,184)
Residential real estate	(182)	(89)	(438)	(808)	(545)
Consumer installment	(67)	(59)	(89)	(397)	(85)
Total charge-offs	(540)	(1,114)	(808)	(2,020)	(4,334)
Recoveries:					
Commercial and industrial	29	22	71	48	54
Construction and land development	1,212	17	8	6	46
Commercial real estate	—	—	119	4	71
Residential real estate	127	313	112	88	134
Consumer installment	11	15	16	19	18
Total recoveries	1,379	367	326	165	323
Net recoveries (charge-offs)	839	(747)	(482)	(1,855)	(4,011)
Provision for loan losses	(485)	200	50	400	3,815
Ending balance	\$ 4,643	4,289	4,836	5,268	6,723
as a % of loans	1.08 %	1.01	1.20	1.37	1.69
as a % of nonperforming loans	196 %	158	433	124	64
Net (recoveries) charge-offs as a % of average loans	(0.19) %	0.18	0.12	0.48	1.03

As noted under “Critical Accounting Policies”, management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management’s evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower’s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.08% at December 31, 2016, compared to 1.01% at December 31, 2015. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net recoveries were \$0.8 million, or 0.19% of average loans, in 2016, compared to net charge-offs of \$0.7 million, or 0.18%, in 2015. In 2016, the Company recognized a recovery of \$1.2 million from the payoff of one nonperforming construction and land development loan. Excluding this recovery, net charge-offs as a percent of average loans would have been 0.08%.

At December 31, 2016 and 2015, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 196% and 158%, respectively. The increase was due to several factors, including certain refinements to our allowance for loan loss methodology described under “Critical Accounting Policies”, loan portfolio growth, and a decrease in nonperforming loans.

At December 31, 2016 and 2015, the Company’s recorded investment in loans considered impaired was \$2.1 million and \$3.4 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) of \$31 thousand and \$121 thousand at each respective date. The decrease was due to two loan payoffs with balances totaling \$1.3 million.

Our regulators, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additional provisions to the allowance for loan losses based on their judgment about information available to them at the time of their examinations.

### Nonperforming Assets

At December 31, 2016 the Company had \$2.5 million in nonperforming assets compared to \$3.0 million at December 31, 2015.

The table below provides information concerning total nonperforming assets and certain asset quality ratios.

<i>(Dollars in thousands)</i>	<b>December 31</b>				
	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Nonperforming assets:</b>					
Nonperforming (nonaccrual) loans	\$ 2,370	2,714	1,117	4,261	10,535
Other real estate owned	152	252	534	3,884	4,919
<b>Total nonperforming assets</b>	<b>\$ 2,522</b>	<b>2,966</b>	<b>1,651</b>	<b>8,145</b>	<b>15,454</b>
as a % of loans and other real estate owned	0.59 %	0.70	0.41	2.10	3.83
as a % of total assets	0.30 %	0.36	0.21	1.08	2.03
Nonperforming loans as a % of total loans	0.55 %	0.64	0.28	1.11	2.65
Accruing loans 90 days or more past due	\$ —	—	—	73	58

The table below provides information concerning the composition of nonaccrual loans at December 31, 2016 and 2015, respectively.

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Nonaccrual loans:</b>		
Commercial and industrial	\$ 37	43
Construction and land development	32	583
Commercial real estate	2,027	1,750
Residential real estate	252	325
Consumer installment	22	13
<b>Total nonaccrual loans / nonperforming loans</b>	<b>\$ 2,370</b>	<b>2,714</b>

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2016, the Company had \$2.4 million in loans on nonaccrual, compared to \$2.7 million at December 31, 2015.

Due to the weakening credit status of a borrower, the Company may elect to formally restructure certain loans to facilitate a repayment plan that minimizes the potential losses that we might incur. Restructured loans, or troubled debt restructurings ("TDRs"), are classified as impaired loans, and if the loans are on nonaccrual status as of the date of restructuring, the loans are included in the nonaccrual loan balances noted above. Nonaccrual loan balances do not include loans that have been restructured that were performing as of the restructure date. At December 31, 2016 and 2015, the Company had \$0.2 million and \$1.1 million, respectively, in accruing TDRs.

At December 31, 2016 and 2015, there were no loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of OREO at December 31, 2016 and 2015, respectively.

<i>(In thousands)</i>	December 31	
	2016	2015
<b>Other real estate owned:</b>		
Commercial:		
Developed lots	\$ 37	252
Residential	115	—
Total other real estate owned	\$ 152	252

At December 31, 2016, the Company held \$0.2 million in OREO, which was acquired from borrowers compared to \$0.3 million at December 31, 2015.

### Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company's primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to \$5.8 million, or 1.4% of total loans at December 31, 2016, compared to \$5.9 million, or 1.4% of total loans at December 31, 2015.

The table below provides information concerning the composition of potential problem loans at December 31, 2016 and 2015, respectively.

<i>(In thousands)</i>	December 31	
	2016	2015
<b>Potential problem loans:</b>		
Commercial and industrial	\$ 233	323
Construction and land development	340	593
Commercial real estate	854	491
Residential real estate	4,326	4,371
Consumer installment	90	114
Total potential problem loans	\$ 5,843	5,892

At December 31, 2016, approximately \$0.5 million or 8.9% of total potential problem loans were past due at least 30 but less than 90 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days as of December 31, 2016 and 2015, respectively.

<i>(In thousands)</i>	December 31	
	2016	2015
<b>Performing loans past due 30 to 89 days:</b>		
Commercial and industrial	\$ 66	49
Construction and land development	395	—
Commercial real estate	242	—
Residential real estate	1,301	1,334
Consumer installment	38	28
Total performing loans past due 30 to 89 days	\$ 2,042	1,411

**Deposits**

<i>(In thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
Noninterest bearing demand	\$ 181,890	156,817
NOW	117,943	118,998
Money market	179,643	183,042
Savings	51,530	45,172
Certificates of deposit under \$100,000	77,255	85,427
Certificates of deposit and other time deposits of \$100,000 or more	120,510	123,740
Brokered certificates of deposit	10,372	10,431
<b>Total deposits</b>	<b>\$ 739,143</b>	<b>723,627</b>

Total deposits were \$739.1 million and \$723.6 million at December 31, 2016 and 2015, respectively. The increase in total deposits of \$15.5 million and the change in deposit mix reflect customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 0.68% in 2016 and 0.73% in 2015. Noninterest bearing deposits were 25% and 22% of total deposits at both December 31, 2016 and 2015, respectively.

**Other Borrowings**

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity of one year or less. The Bank had available federal fund lines totaling \$41.0 million with none outstanding at December 31, 2016 and 2015, respectively. Securities sold under agreements to repurchase totaled \$3.4 million and \$3.0 million at December 31, 2016 and 2015, respectively.

The average rates paid on short-term borrowings was 0.50% in 2016 and 2015, respectively. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the two-year period ended December 31, 2016 is included in Note 10 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes subordinated debentures related to trust preferred securities. The Company had \$3.2 million in junior subordinated debentures related to trust preferred securities outstanding at December 31, 2016 compared to \$7.2 at December 31, 2015. The debentures mature on December 31, 2033 and have been redeemable since December 31, 2008.

The average rates paid on long-term debt were 3.52% in 2016 and 3.40% in 2015.

**CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity was \$82.2 million and \$79.9 million as of December 31, 2016 and 2015, respectively. The change from December 31, 2015 was primarily driven by net earnings of \$8.2 million, partially offset by cash dividends paid of \$3.3 million and an other comprehensive loss due to the change in unrealized gains (losses) on securities available-for-sale, net-of-tax, of \$2.6 million.

The Company's Tier 1 leverage ratio was 10.27%, Common Equity Tier 1 ("CET1") risk-based capital ratio was 16.44%, Tier 1 risk-based capital ratio was 17.00%, and total risk-based capital ratio was 17.95% at December 31, 2016. These ratios exceed the minimum regulatory capital percentages of 5.0% for Tier 1 leverage ratio, 6.5% for CET1 risk-based capital ratio, 8.0% for Tier 1 risk-based capital ratio, and 10.0% for total risk-based capital ratio to be considered "well capitalized." Based on current regulatory standards, the Company is classified as "well capitalized."

**MARKET AND LIQUIDITY RISK MANAGEMENT**

Management's objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. The Bank's Asset Liability Management Committee ("ALCO") is charged with the responsibility of monitoring these policies, which are designed to ensure an acceptable asset/liability composition. Two critical areas of focus for ALCO are interest rate risk and liquidity risk management.

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## Interest Rate Risk Management

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates because assets and liabilities may mature or reprice at different times. For example, if liabilities reprice faster than assets, and interest rates are generally rising, earnings will initially decline. In addition, assets and liabilities may reprice at the same time but by different amounts. For example, when the general level of interest rates is rising, the Company may increase rates paid on interest bearing demand deposit accounts and savings deposit accounts by an amount that is less than the general increase in market interest rates. Also, short-term and long-term market interest rates may change by different amounts. For example, a flattening yield curve may reduce the interest spread between new loan yields and funding costs. Further, the remaining maturity of various assets and liabilities may shorten or lengthen as interest rates change. For example, if long-term mortgage interest rates decline sharply, mortgage-backed securities in the securities portfolio may prepay earlier than anticipated, which could reduce earnings. Interest rates may also have a direct or indirect effect on loan demand, loan losses, mortgage origination volume, the fair value of MSRs and other items affecting earnings.

ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements used to help manage interest rate sensitivity include an earnings simulation and an economic value of equity model.

**Earnings simulation.** Management believes that interest rate risk is best estimated by our earnings simulation modeling. On at least a quarterly basis, the following 12 month time period is simulated to determine a baseline net interest income forecast and the sensitivity of this forecast to changes in interest rates. The baseline forecast assumes an unchanged or flat interest rate environment. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and other factors in order to produce various earnings simulations and estimates.

To help limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income from gradual changes in interest rates. For changes up or down in rates from management's flat interest rate forecast over the next 12 months, policy limits for net interest income variances are as follows:

- +/- 20% for a gradual change of 400 basis points
- +/- 15% for a gradual change of 300 basis points
- +/- 10% for a gradual change of 200 basis points
- +/- 5% for a gradual change of 100 basis points

The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates up or down when compared to the baseline net interest income forecast at December 31, 2016.

<b>Changes in Interest Rates</b>	<b>Net Interest Income % Variance</b>
400 basis points	3.24 %
300 basis points	2.45
200 basis points	1.87
100 basis points	0.33
(100) basis points	0.36
(200) basis points	NM
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2016, our earnings simulation model indicated that we were in compliance with the policy guidelines noted above.

**Economic Value of Equity.** Economic value of equity (“EVE”) measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case EVE. In contrast with our earnings simulation model which evaluates interest rate risk over a 12 month timeframe, EVE uses a terminal horizon which allows for the re-pricing of all assets, liabilities, and off-balance sheet items. Further, EVE is measured using values as of a point in time and does not reflect any actions that ALCO might take in responding to or anticipating changes in interest rates, or market and competitive conditions.

To help limit interest rate risk, we have stated policy guidelines for an instantaneous basis point change in interest rates, such that our EVE should not decrease from our base case by more than the following:

- 45% for an instantaneous change of +/- 400 basis points
- 35% for an instantaneous change of +/- 300 basis points
- 25% for an instantaneous change of +/- 200 basis points
- 15% for an instantaneous change of +/- 100 basis points

The following table reports the variance of EVE assuming an immediate change in interest rates up or down when compared to the baseline EVE at December 31, 2016.

<b>Changes in Interest Rates</b>	<b>EVE % Variance</b>
400 basis points	(22.69) %
300 basis points	(16.33)
200 basis points	(10.50)
100 basis points	(4.54)
(100) basis points	0.22
(200) basis points	NM
(300) basis points	NM
(400) basis points	NM

NM=not meaningful

At December 31, 2016, our EVE model indicated that we were in compliance with the policy guidelines noted above.

Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors, including market perceptions. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types of assets and liabilities may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as “interest rate caps and floors”) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company’s established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (“swaps”) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2016 and 2015, the Company had no derivative contracts to assist in managing interest rate sensitivity.

## Liquidity Risk Management

Liquidity is the Company's ability to convert assets into cash equivalents in order to meet daily cash flow requirements, primarily for deposit withdrawals, loan demand and maturing obligations. Without proper management of its liquidity, the Company could experience higher costs of obtaining funds due to insufficient liquidity, while excessive liquidity can lead to a decline in earnings due to the opportunity cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels: at the Company and at the Bank. The management of liquidity at both levels is essential, because the Company and the Bank have different funding needs and sources, are separate legal entities, and each are subject to regulatory guidelines and requirements.

The primary source of funding and the primary source of liquidity for the Company includes dividends received from the Bank, and secondarily proceeds from the issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the accompanying consolidated balance sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of December 31, 2016, the Bank had a remaining available line of credit with the FHLB totaling \$251.4 million. As of December 31, 2016, the Bank also had \$41.0 million of federal funds lines, with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

The following table presents additional information about our contractual obligations as of December 31, 2016, which by their terms had contractual maturity and termination dates subsequent to December 31, 2016:

	Total	Payments due by period			
		1 year or less	1 to 3 years	3 to 5 years	More than 5 years
<i>(Dollars in thousands)</i>					
<b>Contractual obligations:</b>					
Deposit maturities (1)	\$ 739,143	641,434	81,128	16,581	—
Long-term debt	3,217	—	—	—	3,217
Operating lease obligations	245	155	87	3	—
Total	\$ 742,605	\$641,589	\$81,215	\$16,584	\$3,217

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the "1 year or less" column

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next 12 months.

## Off-Balance Sheet Arrangements

At December 31, 2016, the Bank had outstanding standby letters of credit of \$7.4 million and unfunded loan commitments outstanding of \$46.0 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

*Residential mortgage lending and servicing activities*

Since 2009, we have primarily sold residential mortgage loans in the secondary market to Fannie Mae while retaining the servicing of these loans. The sale agreements for these residential mortgage loans with Fannie Mae and other investors include various representations and warranties regarding the origination and characteristics of the residential mortgage loans. Although the representations and warranties vary among investors, they typically cover ownership of the loan, validity of the lien securing the loan, the absence of delinquent taxes or liens against the property securing the loan, compliance with loan criteria set forth in the applicable agreement, compliance with applicable federal, state, and local laws, among other matters.

As of December 31, 2016, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was \$338.4 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or the documents we deliver are defective. Investors also may require the repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

In 2016, as a result of the representation and warranty provisions contained in the Company's sale agreements with Fannie Mae, the Company was required to repurchase one loan with an aggregate principal balance of \$196 thousand that was current as to principal and interest at the time of repurchase. During 2015, the Company was required to repurchase two loans with an aggregate principal balance of \$287 thousand that were current as to principal and interest at the time of repurchase and reimburse Fannie Mae approximately \$37 thousand related to a make whole request. At December 31, 2016, the Company had no pending repurchase requests related to representation and warranty provisions.

Also, in January 2015, the Company voluntarily repurchased from Fannie Mae ten investment property loans with an aggregate principal balance of \$4.0 million that were made to the same borrower and were current as to principal and interest. At the date of repurchase, the aggregate fair value of these ten investment property loans was greater than the repurchase price required by Fannie Mae. As part of the Company's quality control review procedures, one of these ten loans was self-reported to Fannie Mae in 2014 for possible breaches related to representation and warranty provisions. After further investigation, the Company identified certain underwriting deficiencies for the other nine investment property loans and submitted the voluntary repurchase request to Fannie Mae. In response to the quality control review findings related to this one borrower, the Company has put additional controls in place for investment property loans originated for sale, including additional quality control reviews and management approvals. Furthermore, management performed additional reviews of investment property loans originated for sale, including a review of the number of loans to one borrower, and does not believe there is any material exposure related to representation and warranty provisions for these loans.

We service all residential mortgage loans originated and sold by us to Fannie Mae. As servicer, our primary duties are to: (1) collect payments due from borrowers; (2) advance certain delinquent payments of principal and interest; (3) maintain and administer any hazard, title, or primary mortgage insurance policies relating to the mortgage loans; (4) maintain any required escrow accounts for payment of taxes and insurance and administer escrow payments; and (5) foreclose on defaulted mortgage loans or take other actions to mitigate the potential losses to investors consistent with the agreements governing our rights and duties as servicer.

The agreement under which we act as servicer generally specifies a standard of responsibility for actions taken by us in such capacity and provides protection against expenses and liabilities incurred by us when acting in compliance with the respective servicing agreements. However, if we commit a material breach of our obligations as servicer, we may be subject to termination if the breach is not cured within a specified period following notice. The standards governing servicing and the possible remedies for violations of such standards are determined by servicing guides issued by Fannie Mae as well as the contract provisions established between Fannie Mae and the Bank. Remedies could include repurchase of an affected loan.

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Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of December 31, 2016, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, the results of our quality control reviews, and the fact that 99% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

### **Effects of Inflation and Changing Prices**

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

### **CURRENT ACCOUNTING DEVELOPMENTS**

The following Accounting Standards Updates ("Updates" or "ASUs") have been issued by the FASB but are not yet effective.

- ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*;
- ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)– Deferral of the Effective Date*;
- ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*;
- ASU 2016-02, *Leases (Topic 842)*;
- ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*;
- ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*; and
- ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*

Information about these pronouncements is described in more detail below.

ASU 2014-09, *Revenue from Contracts with Customers*, provides a comprehensive and converged standard on revenue recognition. The new guidance is intended to improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods and services. This guidance also requires new qualitative and quantitative disclosures related to revenue from contracts with customers. In August 2015, FASB issued ASU 2015-14, *Revenue from Contracts with Customers – Deferral of the Effective Date*, which defers the effective date by one year. With the deferral, these changes are effective for the Company in the first quarter of 2018 with retrospective application to each prior reporting period or with the cumulative effect of initially applying this Update at the date of initial application. Early adoption is not permitted. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

ASU 2016-01, *Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Some of the amendments include the following: 1) Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; 2) Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; 4) Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

ASU 2016-02, *Leases*, requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for lease term. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The amendment should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.

ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): - Measurement of Credit Losses on Financial Instruments*, amends guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, the new standard eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses using a broader range of information regarding past events, current conditions and forecasts assessing the collectability of cash flows. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP, however the new standard will require that credit losses be presented as an allowance rather than as a write-down. The new guidance affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public business entities that are SEC filers, the new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019 early adoption is permitted beginning in 2019. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, provides guidance on eight specific cash flow issues where current GAAP is either unclear or does not include specific guidance on classification in the statement of cash flows. The new guidance is effective for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted cash*, amends guidance on how the statement of cash flows presents the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this Update do not provide a definition of restricted cash or restricted cash equivalents. The new guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments are applied using a retrospective transition method to each period transitioned. The Company is currently evaluating the impact of the new guidance on its consolidated financial statements.

**Table 1 – Explanation of Non-GAAP Financial Measures**

In addition to results presented in accordance with GAAP, this annual report on Form 10-K includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation of total revenue and the calculation of the efficiency ratio.

The Company believes the presentation of net interest income on a tax-equivalent basis provides comparability of net interest income from both taxable and tax-exempt sources and facilitates comparability within the industry. Although the Company believes these non-GAAP financial measures enhance investors' understanding of its business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliation of these non-GAAP financial measures from GAAP to non-GAAP is presented below.

<i>(In thousands)</i>	<b>Year ended December 31</b>				
	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Net interest income (GAAP)	\$ 22,732	22,718	21,453	20,922	20,897
Tax-equivalent adjustment	1,276	1,342	1,288	1,440	1,642
Net interest income (Tax-equivalent)	\$ 24,008	24,060	22,741	22,362	22,539

**Table 2 - Selected Financial Data**

<i>(Dollars in thousands, except per share amounts)</i>	<b>Year ended December 31</b>				
	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Income statement</b>					
Tax-equivalent interest income (a)	\$ 28,092	28,495	28,105	28,898	30,709
Total interest expense	4,084	4,435	5,364	6,536	8,170
Tax equivalent net interest income (a)	24,008	24,060	22,741	22,362	22,539
Provision for loan losses	(485)	200	50	400	3,815
Total noninterest income	3,383	4,532	3,933	7,298	10,483
Total noninterest expense	15,348	16,372	15,104	18,412	19,383
Net earnings before income taxes and tax-equivalent adjustment	12,528	12,020	11,520	10,848	9,824
Tax-equivalent adjustment	1,276	1,342	1,288	1,440	1,642
Income tax expense	3,102	2,820	2,784	2,290	1,419
Net earnings	\$ 8,150	7,858	7,448	7,118	6,763
<b>Per share data:</b>					
Basic and diluted net earnings	\$ 2.24	2.16	2.04	1.95	1.86
Cash dividends declared	\$ 0.90	0.88	0.86	0.84	0.82
Weighted average shares outstanding					
Basic and diluted	3,643,504	3,643,428	3,643,278	3,643,003	3,642,831
Shares outstanding	3,643,523	3,643,478	3,643,328	3,643,118	3,642,903
Book value	\$ 22.55	21.94	20.80	17.70	19.26
Common stock price					
High	\$ 31.31	30.39	25.80	25.75	26.65
Low	24.56	23.15	22.10	20.80	18.23
Period-end	\$ 31.31	29.62	23.64	25.00	20.85
To earnings ratio	13.98x	13.78	11.59	12.89	11.21
To book value	139 %	135	114	141	108
<b>Performance ratios:</b>					
Return on average equity	9.65 %	9.98	10.53	10.33	9.85
Return on average assets	0.98 %	0.98	0.97	0.94	0.90
Dividend payout ratio	40.18 %	40.74	42.16	43.08	44.09
Average equity to average assets	10.14 %	9.79	9.17	9.07	9.09
<b>Asset Quality:</b>					
Allowance for loan losses as a % of:					
Loans	1.08 %	1.01	1.20	1.37	1.69
Nonperforming loans	196 %	158	433	124	64
Nonperforming assets as a % of:					
Loans and other real estate owned	0.59 %	0.70	0.41	2.10	3.83
Total assets	0.30 %	0.36	0.21	1.08	2.03
Nonperforming loans as % of loans	0.55 %	0.64	0.28	1.11	2.65
Net (recoveries) charge-offs as a % of average loans	(0.19) %	0.18	0.12	0.48	1.03
<b>Capital Adequacy:</b>					
CET 1 risk-based capital ratio	16.44 %	15.28	na	na	na
Tier 1 risk-based capital ratio	17.00 %	16.57	17.45	17.19	16.20
Total risk-based capital ratio	17.95 %	17.44	18.54	18.40	17.46
Tier 1 leverage ratio	10.27 %	10.35	10.32	10.10	9.58
<b>Other financial data:</b>					
Net interest margin (a)	3.05 %	3.17	3.15	3.16	3.21
Effective income tax rate	27.57 %	26.41	27.21	24.34	17.34
Efficiency ratio (b)	56.03 %	57.26	56.62	62.08	58.70
<b>Selected period end balances:</b>					
Securities	\$ 243,572	241,687	267,603	271,219	259,475
Loans, net of unearned income	430,946	426,410	402,954	383,339	398,193
Allowance for loan losses	4,643	4,289	4,836	5,268	6,723
Total assets	831,943	817,189	789,231	751,343	759,833
Total deposits	739,143	723,627	693,390	668,844	636,817
Long-term debt	3,217	7,217	12,217	12,217	47,217
Total stockholders' equity	82,177	79,949	75,799	64,485	70,149

(a) Tax-equivalent. See "Table 1 - Explanation of Non-GAAP Financial Measures".

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

**Table 3 - Average Balance and Net Interest Income Analysis**

	Year ended December 31					
	2016			2015		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<i>(Dollars in thousands)</i>						
<b>Interest-earning assets:</b>						
Loans and loans held for sale (1)	\$ 432,180	\$ 20,453	4.73%	\$ 413,616	\$ 20,484	4.95%
Securities - taxable	166,870	3,282	1.97%	186,845	3,851	2.06%
Securities - tax-exempt (2)	68,507	3,754	5.48%	68,386	3,946	5.77%
Total securities	235,377	7,036	2.99%	255,231	7,797	3.05%
Federal funds sold	49,446	249	0.50%	58,607	137	0.23%
Interest bearing bank deposits	70,064	354	0.51%	31,028	77	0.25%
Total interest-earning assets	787,067	28,092	3.57%	758,482	28,495	3.76%
Cash and due from banks	13,126			13,232		
Other assets	32,127			32,413		
Total assets	\$ 832,320			\$ 804,127		
<b>Interest-bearing liabilities:</b>						
Deposits:						
NOW	\$ 121,723	333	0.27%	\$ 115,146	348	0.30%
Savings and money market	232,601	890	0.38%	215,936	832	0.39%
Certificates of deposits						
less than \$100,000	80,760	781	0.97%	91,136	935	1.03%
Certificates of deposits and other time deposits of \$100,000 or more	131,902	1,837	1.39%	140,831	2,020	1.43%
Total interest-bearing deposits	566,986	3,841	0.68%	563,049	4,135	0.73%
Short-term borrowings	2,973	15	0.50%	3,601	18	0.50%
Long-term debt	6,474	228	3.52%	8,286	282	3.40%
Total interest-bearing liabilities	576,433	4,084	0.71%	574,936	4,435	0.77%
Noninterest-bearing deposits	167,695			147,259		
Other liabilities	3,760			3,208		
Stockholders' equity	84,432			78,724		
Total liabilities and stockholders' equity	\$ 832,320			\$ 804,127		
Net interest income and margin		\$ 24,008	3.05%		\$ 24,060	3.17%

(1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.

(2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

**Table 4 - Volume and Rate Variance Analysis**

<i>(Dollars in thousands)</i>	<u>Years ended December 31, 2016 vs. 2015</u>			<u>Years ended December 31, 2015 vs. 2014</u>		
	Net Change	Due to change in		Net Change	Due to change in	
		Rate (2)	Volume (2)		Rate (2)	Volume (2)
<b>Interest income:</b>						
Loans and loans held for sale	\$ (31)	(910)	879	\$ 933	(317)	1,250
Securities - taxable	(569)	(176)	(393)	(776)	(347)	(429)
Securities - tax-exempt (1)	(192)	(199)	7	156	(162)	318
Total securities	(761)	(375)	(386)	(620)	(509)	(111)
Federal funds sold	112	158	(46)	28	22	6
Interest bearing bank deposits	277	80	197	49	(12)	61
Total interest income	\$ (403)	(1,047)	644	\$ 390	(816)	1,206
<b>Interest expense:</b>						
Deposits:						
NOW	\$ (15)	(33)	18	\$ 17	(12)	29
Savings and money market	58	(6)	64	(150)	(243)	93
Certificates of deposits less than \$100,000	(154)	(54)	(100)	(234)	(127)	(107)
Certificates of deposits and other time deposits of \$100,000 or more	(183)	(59)	(124)	(425)	(207)	(218)
Total interest-bearing deposits	(294)	(152)	(142)	(792)	(589)	(203)
Short-term borrowings	(3)	—	(3)	(1)	—	(1)
Long-term debt	(54)	10	(64)	(136)	(2)	(134)
Total interest expense	(351)	(142)	(209)	(929)	(591)	(338)
Net interest income	\$ (52)	(905)	853	\$ 1,319	(225)	1,544

(1) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

(2) Changes that are not solely a result of volume or rate have been allocated to volume.

**Table 5 - Loan Portfolio Composition**

<i>(In thousands)</i>	<b>December 31</b>				
	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Commercial and industrial	\$ 49,850	52,479	54,329	57,780	59,334
Construction and land development	41,650	43,694	37,298	36,479	37,631
Commercial real estate	220,439	203,853	192,006	174,920	183,611
Residential real estate	110,855	116,673	107,641	101,706	105,631
Consumer installment	8,712	10,220	12,335	12,893	12,219
Total loans	431,506	426,919	403,609	383,778	398,426
Less: unearned income	(560)	(509)	(655)	(439)	(233)
Loans, net of unearned income	430,946	426,410	402,954	383,339	398,193
Less: allowance for loan losses	(4,643)	(4,289)	(4,836)	(5,268)	(6,723)
Loans, net	\$ 426,303	422,121	398,118	378,071	391,470

**Table 6 - Loan Maturities and Sensitivities to Changes in Interest Rates**

		<b>December 31, 2016</b>						
		<b>1 year</b>	<b>1 to 5</b>	<b>After 5</b>		<b>Adjustable</b>	<b>Fixed</b>	
<i>(Dollars in thousands)</i>		<b>or less</b>	<b>years</b>	<b>years</b>	<b>Total</b>	<b>Rate</b>	<b>Rate</b>	<b>Total</b>
Commercial and industrial	\$	32,599	8,777	8,474	49,850	18,290	31,560	49,850
Construction and land development		21,434	17,689	2,527	41,650	20,335	21,315	41,650
Commercial real estate		24,144	82,353	113,942	220,439	14,359	206,080	220,439
Residential real estate		7,185	23,616	80,054	110,855	60,678	50,177	110,855
Consumer installment		3,164	5,208	340	8,712	1,206	7,506	8,712
<b>Total loans</b>	<b>\$</b>	<b>88,526</b>	<b>137,643</b>	<b>205,337</b>	<b>431,506</b>	<b>114,868</b>	<b>316,638</b>	<b>431,506</b>

**Table 7 - Allowance for Loan Losses and Nonperforming Assets**

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>				
	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 4,289	4,836	5,268	6,723	6,919
Charge-offs:					
Commercial and industrial	(97)	(100)	(46)	(514)	(289)
Construction and land development	—	—	(235)	(39)	(231)
Commercial real estate	(194)	(866)	—	(262)	(3,184)
Residential real estate	(182)	(89)	(438)	(808)	(545)
Consumer installment	(67)	(59)	(89)	(397)	(85)
Total charge-offs	(540)	(1,114)	(808)	(2,020)	(4,334)
Recoveries:					
Commercial and industrial	29	22	71	48	54
Construction and land development	1,212	17	8	6	46
Commercial real estate	—	—	119	4	71
Residential real estate	127	313	112	88	134
Consumer installment	11	15	16	19	18
Total recoveries	1,379	367	326	165	323
Net recoveries (charge-offs)	839	(747)	(482)	(1,855)	(4,011)
Provision for loan losses	(485)	200	50	400	3,815
Ending balance	\$ 4,643	4,289	4,836	5,268	6,723
as a % of loans	1.08 %	1.01	1.20	1.37	1.69
as a % of nonperforming loans	196 %	158	433	124	64
Net (recoveries) charge-offs as % of average loans	(0.19) %	0.18	0.12	0.48	1.03
<b>Nonperforming assets:</b>					
Nonaccrual/nonperforming loans	\$ 2,370	2,714	1,117	4,261	10,535
Other real estate owned	152	252	534	3,884	4,919
Total nonperforming assets	\$ 2,522	2,966	1,651	8,145	15,454
as a % of loans and other real estate owned	0.59 %	0.70	0.41	2.10	3.83
as a % total assets	0.30 %	0.36	0.21	1.08	2.03
Nonperforming loans as a % of total loans	0.55 %	0.64	0.28	1.11	2.65
Accruing loans 90 days or more past due	\$ —	—	—	73	58

**Table 8 - Allocation of Allowance for Loan Losses**

<i>(Dollars in thousands)</i>	December 31									
	2016		2015		2014		2013		2012	
	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	\$ 540	11.6	\$ 523	12.3	\$ 639	13.5	\$ 386	15.1	\$ 812	14.9
Construction and land development	812	9.7	669	10.2	974	9.2	366	9.5	1,545	9.4
Commercial real estate	2,071	51.0	1,879	47.8	1,928	47.5	3,186	45.5	3,137	46.1
Residential real estate	1,107	25.7	1,059	27.3	1,119	26.7	1,114	26.5	1,126	26.5
Consumer installment	113	2.0	159	2.4	176	3.1	216	3.4	103	3.1
Total allowance for loan losses	\$ 4,643		\$ 4,289		\$ 4,836		\$ 5,268		\$ 6,723	

\* Loan balance in each category expressed as a percentage of total loans.

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**Table 9 - CDs and Other Time Deposits of \$100,000 or More**

*(Dollars in thousands)*

**December 31, 2016**

**Maturity of:**

3 months or less	\$	14,336
Over 3 months through 6 months		9,439
Over 6 months through 12 months		48,289
Over 12 months		58,818
<hr/>		
Total CDs and other time deposits of \$100,000 or more (1)	\$	130,882
<hr/>		

(1) Includes brokered certificates of deposit.

**Management's Report on Internal Control Over Financial Reporting**

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation and fair presentation of published financial statements. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Under the direction of the Company's Chief Executive Officer and Chief Financial Officer, management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2016 in accordance with the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control – Integrated Framework (2013). Based on this assessment, management has concluded that such internal control over financial reporting was effective as of December 31, 2016.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to the final rules of the Securities and Exchange Commission that permit the Company to provide only a management's report in this annual report.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders  
Auburn National Bancorporation, Inc.:

We have audited the accompanying consolidated balance sheets of Auburn National Bancorporation, Inc. and subsidiaries (the "Company") as of December 31, 2016 and 2015, and the related consolidated statements of earnings, comprehensive income, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Auburn National Bancorporation, Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

A handwritten signature in cursive script that reads "Elliott Davis Decosimo, LLC".

Greenville, South Carolina  
March 3, 2017

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**

	<b>December 31</b>	
<i>(Dollars in thousands, except share data)</i>	<b>2016</b>	<b>2015</b>
<b>Assets:</b>		
Cash and due from banks	\$ 15,673	\$ 9,806
Federal funds sold	42,096	57,395
Interest bearing bank deposits	63,508	46,729
Cash and cash equivalents	121,277	113,930
Securities available-for-sale	243,572	241,687
Loans held for sale	1,497	1,540
Loans, net of unearned income	430,946	426,410
Allowance for loan losses	(4,643)	(4,289)
Loans, net	426,303	422,121
Premises and equipment, net	12,602	11,866
Bank-owned life insurance	17,888	17,433
Other real estate owned	152	252
Other assets	8,652	8,360
<b>Total assets</b>	<b>\$ 831,943</b>	<b>\$ 817,189</b>
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 181,890	\$ 156,817
Interest-bearing	557,253	566,810
Total deposits	739,143	723,627
Federal funds purchased and securities sold under agreements to repurchase	3,366	2,951
Long-term debt	3,217	7,217
Accrued expenses and other liabilities	4,040	3,445
<b>Total liabilities</b>	<b>749,766</b>	<b>737,240</b>
<b>Stockholders' equity:</b>		
Preferred stock of \$.01 par value; authorized 200,000 shares; issued shares - none	—	—
Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,767	3,766
Retained earnings	85,716	80,845
Accumulated other comprehensive (loss) income, net	(708)	1,937
Less treasury stock, at cost - 313,612 shares and 313,657 shares at December 31, 2016 and 2015, respectively	(6,637)	(6,638)
<b>Total stockholders' equity</b>	<b>82,177</b>	<b>79,949</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 831,943</b>	<b>\$ 817,189</b>

*See accompanying notes to consolidated financial statements*

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Earnings**

	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
<i>(Dollars in thousands, except share and per share data)</i>		
<b>Interest income:</b>		
Loans, including fees	\$ 20,453	\$ 20,484
Securities:		
Taxable	3,282	3,851
Tax-exempt	2,478	2,604
Federal funds sold and interest bearing bank deposits	603	214
<b>Total interest income</b>	<b>26,816</b>	<b>27,153</b>
<b>Interest expense:</b>		
Deposits	3,841	4,135
Short-term borrowings	15	18
Long-term debt	228	282
<b>Total interest expense</b>	<b>4,084</b>	<b>4,435</b>
<b>Net interest income</b>	<b>22,732</b>	<b>22,718</b>
<b>Provision for loan losses</b>	<b>(485)</b>	<b>200</b>
<b>Net interest income after provision for loan losses</b>	<b>23,217</b>	<b>22,518</b>
<b>Noninterest income:</b>		
Service charges on deposit accounts	773	823
Mortgage lending	947	1,444
Bank-owned life insurance	456	747
Other	1,428	1,502
Securities (losses) gains, net	(221)	16
<b>Total noninterest income</b>	<b>3,383</b>	<b>4,532</b>
<b>Noninterest expense:</b>		
Salaries and benefits	9,826	9,293
Net occupancy and equipment	1,474	1,547
Professional fees	825	756
FDIC and other regulatory assessments	406	472
Other real estate owned, net	(371)	11
(Gain) loss on early extinguishment of debt	(790)	362
Other	3,978	3,931
<b>Total noninterest expense</b>	<b>15,348</b>	<b>16,372</b>
<b>Earnings before income taxes</b>	<b>11,252</b>	<b>10,678</b>
<b>Income tax expense</b>	<b>3,102</b>	<b>2,820</b>
<b>Net earnings</b>	<b>\$ 8,150</b>	<b>\$ 7,858</b>
<b>Net earnings per share:</b>		
Basic and diluted	\$ 2.24	\$ 2.16
<b>Weighted average shares outstanding:</b>		
Basic and diluted	3,643,504	3,643,428

*See accompanying notes to consolidated financial statements*

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Comprehensive Income**

<i>(Dollars in thousands)</i>	Year ended December 31	
	2016	2015
<b>Net earnings</b>	\$ 8,150	\$ 7,858
<b>Other comprehensive loss, net of tax:</b>		
Unrealized net holding loss on all other securities	(2,784)	(496)
Reclassification adjustment for net loss (gain) on securities recognized in net earnings	139	(10)
<b>Other comprehensive loss</b>	(2,645)	(506)
<b>Comprehensive income</b>	\$ 5,505	\$ 7,352

*See accompanying notes to consolidated financial statements*

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity**

<i>(Dollars in thousands, except share data)</i>	Common Stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Treasury stock	Total
	Shares	Amount					
<b>Balance, December 31, 2014</b>	3,957,135	\$ 39	3,763	76,193	2,443	(6,639)	\$ 75,799
Net earnings	—	—	—	7,858	—	—	7,858
Other comprehensive loss	—	—	—	—	(506)	—	(506)
Cash dividends paid (\$0.88 per share)	—	—	—	(3,206)	—	—	(3,206)
Sale of treasury stock (150 shares)	—	—	3	—	—	1	4
<b>Balance, December 31, 2015</b>	3,957,135	\$ 39	\$ 3,766	\$ 80,845	\$ 1,937	\$ (6,638)	\$ 79,949
Net earnings	—	—	—	8,150	—	—	8,150
Other comprehensive loss	—	—	—	—	(2,645)	—	(2,645)
Cash dividends paid (\$0.90 per share)	—	—	—	(3,279)	—	—	(3,279)
Sale of treasury stock (45 shares)	—	—	1	—	—	1	2
<b>Balance, December 31, 2016</b>	3,957,135	\$ 39	\$ 3,767	\$ 85,716	\$ (708)	\$ (6,637)	\$ 82,177

*See accompanying notes to consolidated financial statements*

**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**

<i>(In thousands)</i>	Year ended December 31	
	2016	2015
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 8,150	\$ 7,858
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	(485)	200
Depreciation and amortization	1,200	1,166
Premium amortization and discount accretion, net	1,677	1,549
Deferred tax expense	461	620
Net loss (gain) on securities available for sale	221	(16)
Net gain on sale of loans held for sale	(764)	(1,152)
Net (gain) loss on other real estate owned	(392)	1
(Gain) loss on early extinguishment of debt	(790)	362
Loans originated for sale	(42,860)	(63,566)
Proceeds from sale of loans	43,343	64,623
Increase in cash surrender value of bank owned life insurance	(455)	(471)
Income recognized from death benefit on bank-owned life insurance	—	(276)
Net decrease (increase) in other assets	412	(350)
Net increase in accrued expenses and other liabilities	769	304
Net cash provided by operating activities	\$ 10,487	\$ 10,852
<b>Cash flows from investing activities:</b>		
Proceeds from sales of securities available-for-sale	26,110	—
Proceeds from maturities of securities available-for-sale	63,410	31,334
Purchase of securities available-for-sale	(97,494)	(7,752)
Increase in loans, net	(4,097)	(24,212)
Net purchases of premises and equipment	(1,206)	(1,534)
(Increase) decrease in FHLB stock	(25)	191
Proceeds from bank-owned life insurance death benefit	—	1,319
Proceeds from sale of other real estate owned	720	290
Net cash used in investing activities	\$ (12,582)	\$ (364)
<b>Cash flows from financing activities:</b>		
Net increase in noninterest-bearing deposits	25,073	26,657
Net (decrease) increase in interest-bearing deposits	(9,557)	3,580
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	415	(1,730)
Repayments or retirement of long-term debt	(3,210)	(5,362)
Dividends paid	(3,279)	(3,206)
Net cash provided by financing activities	\$ 9,442	\$ 19,939
Net change in cash and cash equivalents	\$ 7,347	\$ 30,427
Cash and cash equivalents at beginning of period	113,930	83,503
<b>Cash and cash equivalents at end of period</b>	<b>\$ 121,277</b>	<b>\$ 113,930</b>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 4,108	\$ 4,528
Income taxes	2,203	2,308
<b>Supplemental disclosure of non-cash transactions:</b>		
Real estate acquired through foreclosure	\$ 400	\$ 9

*See accompanying notes to consolidated financial statements*

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**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**

**NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Business**

Auburn National Bancorporation, Inc. (the “Company”) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, AuburnBank (the “Bank”). AuburnBank is a commercial bank located in Auburn, Alabama. The Bank provides a full range of banking services in its primary market area, Lee County, which includes the Auburn-Opelika Metropolitan Statistical Area.

**Basis of Presentation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I is an affiliate of the Company and was included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

**Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the balance sheet date and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, fair value measurements, valuation of other real estate owned, and valuation of deferred tax assets.

**Reclassifications**

Certain amounts reported in the prior period have been reclassified to conform to the current-period presentation. These reclassifications had no impact on the Company’s previously reported net earnings or total stockholders’ equity.

**Accounting Standards Adopted in 2016**

In the first quarter of 2016, the Company adopted new guidance related to the following Accounting Standards Updates (“Updates” or “ASUs”):

- ASU 2015-02, *Amendments to the Consolidation Analysis*;
- ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*; and
- ASU 2015-05, *Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*.

Information about these pronouncements is described in more detail below.

ASU 2015-02, *Amendments to the Consolidation Analysis*, affects reporting entities that are required to evaluate whether they should consolidate certain legal entities. Specifically, the amendments: (1) Modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities; (2) Eliminate the presumption that a general partner should consolidate a limited partnership; (3) Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships; and (4) Provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. Adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, requires that debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the debt liability, rather than as an asset. Adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer's accounting for service contracts. Adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

### **Cash Equivalents**

Cash equivalents include cash on hand, cash items in process of collection, amounts due from banks, including interest bearing deposits with other banks, and federal funds sold.

### **Securities**

Securities are classified based on management's intention at the date of purchase. At December 31, 2016, all of the Company's securities were classified as available-for-sale. Securities available-for-sale are used as part of the Company's interest rate risk management strategy, and they may be sold in response to changes in interest rates, changes in prepayment risks or other factors. All securities classified as available-for-sale are recorded at fair value with any unrealized gains and losses reported in accumulated other comprehensive income, net of the deferred income tax effects. Interest and dividends on securities, including the amortization of premiums and accretion of discounts are recognized in interest income over the anticipated life of the security using the effective interest method, taking into consideration prepayment assumptions. Realized gains and losses from the sale of securities are determined using the specific identification method.

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses), net.

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, as a realized loss in securities gains (losses), and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

### **Loans held for sale**

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Loan sales are recognized when the transaction closes, the proceeds are collected, and ownership is transferred. Continuing involvement, through the sales agreement, consists of the right to service the loan for a fee for the life of the loan, if applicable. Gains on the sale of loans held for sale are recorded net of related costs, such as commissions, and reflected as a component of mortgage lending income in the consolidated statements of earnings.

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In the course of conducting the Bank's mortgage lending activities of originating mortgage loans and selling those loans in the secondary market, the Bank makes various representations and warranties to the purchaser of the mortgage loans. Every loan closed by the Bank's mortgage center is run through a government agency automated underwriting system. Any exceptions noted during this process are remedied prior to sale. These representations and warranties also apply to underwriting the real estate appraisal opinion of value for the collateral securing these loans. Failure by the Company to comply with the underwriting and/or appraisal standards could result in the Company being required to repurchase the mortgage loan or to reimburse the investor for losses incurred (make whole requests) if such failure cannot be cured by the Company within the specified period following discovery.

## **Loans**

Loans are reported at their outstanding principal balances, net of any unearned income, charge-offs, and any deferred fees or costs on originated loans. Interest income is accrued based on the principal balance outstanding. Loan origination fees, net of certain loan origination costs, are deferred and recognized in interest income over the contractual life of the loan using the effective interest method. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period, which results in a recorded amount that approximates fair value.

The accrual of interest on loans is discontinued when there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or the principal or interest is more than 90 days past due, unless the loan is both well-collateralized and in the process of collection. Generally, all interest accrued but not collected for loans that are placed on nonaccrual status is reversed against current interest income. Interest collections on nonaccrual loans are generally applied as principal reductions. The Company determines past due or delinquency status of a loan based on contractual payment terms.

A loan is considered impaired when it is probable the Company will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement. Individually identified impaired loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as part of the allowance for loan losses. Changes to the valuation allowance are recorded as a component of the provision for loan losses.

Impaired loans also include troubled debt restructurings ("TDRs"). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. The concessions granted most frequently for TDRs involve reductions or delays in required payments of principal and interest for a specified time, the rescheduling of payments in accordance with a bankruptcy plan or the charge-off of a portion of the loan. In most cases, the conditions of the credit also warrant nonaccrual status, even after the restructuring occurs. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructuring. TDR loans may be returned to accrual status if there has been at least a six-month sustained period of repayment performance by the borrower.

## **Allowance for Loan Losses**

The allowance for loan losses is maintained at a level that management believes is adequate to absorb probable losses inherent in the loan portfolio. Loan losses are charged against the allowance when they are known. Subsequent recoveries are credited to the allowance. Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, growth, composition of the loan portfolio, homogeneous pools of loans, risk ratings of specific loans, historical loan loss factors, identified impaired loans and other factors related to the portfolio. This evaluation is performed quarterly and is inherently subjective, as it requires various material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on any impaired loans. In addition, regulatory agencies, as an integral part of their examination process, will periodically review the Company's allowance for loan losses, and may require the Company to record additions to the allowance based on their judgment about information available to them at the time of their examinations.

## **Premises and Equipment**

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on a straight-line method over the useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured.

**Other Real Estate Owned**

Other real estate owned (“OREO”) includes properties acquired through, or in lieu of, loan foreclosure that are held for sale and are initially recorded at the lower of the loan’s carrying amount or fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying value amount or fair value less cost to sell. Gains or losses realized upon sale of OREO and additional losses related to subsequent valuation adjustments are determined on a specific property basis and are included as a component of noninterest expense along with holding costs.

**Nonmarketable equity investments**

Nonmarketable equity investments include equity securities that are not publicly traded and securities acquired for various purposes. The Bank is required to maintain certain minimum levels of equity investments with certain regulatory and other entities in which the Bank has an ongoing business relationship based on the Bank’s common stock and surplus (with regard to the relationship with the Federal Reserve Bank) or outstanding borrowings (with regard to the relationship with the Federal Home Loan Bank of Atlanta). These securities are accounted for under the cost method and are included in other assets. For cost-method investments, on a quarterly basis, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment. If the Company determines that a decline in value is other-than-temporary, the Company will recognize the estimated loss in securities gains (losses), net.

**Transfers of Financial Assets**

Transfers of an entire financial asset (i.e. loan sales), a group of entire financial assets, or a participating interest in an entire financial asset (i.e. loan participations sold) are accounted for as sales when control over the assets have been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Mortgage Servicing Rights**

The Company recognizes as assets the rights to service mortgage loans for others, known as MSR’s. The Company determines the fair value of MSR’s at the date the loan is transferred. An estimate of the Company’s MSR’s is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees.

Subsequent to the date of transfer, the Company has elected to measure its MSR’s under the amortization method. Under the amortization method, MSR’s are amortized in proportion to, and over the period of, estimated net servicing income. The amortization of MSR’s is analyzed monthly and is adjusted to reflect changes in prepayment speeds, as well as other factors. MSR’s are evaluated for impairment based on the fair value of those assets. Impairment is determined by stratifying MSR’s into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSR’s exceeds fair value, a valuation allowance is established through a charge to earnings. The valuation allowance is adjusted as the fair value changes. MSR’s are included in the other assets category in the accompanying consolidated balance sheets.

**Derivative Instruments**

In accordance with Accounting Standards Codification (“ASC”) Topic 815, *Derivatives and Hedging*, all derivative instruments are recorded on the consolidated balance sheet at their respective fair values. The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. If the derivative instrument is not designated as part of a hedging relationship, the gain or loss on the derivative instrument is recognized in earnings in the period of change. None of the derivatives utilized by the Company have been designated as a hedge.

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## Securities sold under agreements to repurchase

Securities sold under agreements to repurchase generally mature less than one year from the transaction date. Securities sold under agreements to repurchase are reflected as a secured borrowing in the accompanying consolidated balance sheets at the amount of cash received in connection with each transaction.

## Income Taxes

Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. The net deferred tax asset is reflected as a component of other assets in the accompanying consolidated balance sheets.

Income tax expense or benefit for the year is allocated among continuing operations and other comprehensive income (loss), as applicable. The amount allocated to continuing operations is the income tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (1) changes in certain circumstances that cause a change in judgment about the realization of deferred tax assets in future years, (2) changes in income tax laws or rates, and (3) changes in income tax status, subject to certain exceptions. The amount allocated to other comprehensive income (loss) is related solely to changes in the valuation allowance on items that are normally accounted for in other comprehensive income (loss) such as unrealized gains or losses on available-for-sale securities.

In accordance with ASC 740, *Income Taxes*, a tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. It is the Company’s policy to recognize interest and penalties related to income tax matters in income tax expense. The Company and its wholly-owned subsidiaries file a consolidated income tax return.

## Fair Value Measurements

ASC 820, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. ASC 820 applies only to fair-value measurements that are already required or permitted by other accounting standards. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. For more information related to fair value measurements, please refer to Note 17, Fair Value.

## Subsequent Events

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to December 31, 2016. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

**NOTE 2: BASIC AND DILUTED NET EARNINGS PER SHARE**

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the year. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company's common stock. As of December 31, 2016 and 2015, respectively, the Company had no such securities or other rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted net earnings per share calculation.

The basic and diluted net earnings per share computations for the respective years are presented below.

<i>(Dollars in thousands, except share and per share data)</i>	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Basic and diluted:</b>		
Net earnings	\$ 8,150	\$ 7,858
Weighted average common shares outstanding	3,643,504	3,643,428
Net earnings per share	\$ 2.24	\$ 2.16

**NOTE 3: VARIABLE INTEREST ENTITIES**

Generally, a variable interest entity ("VIE") is a corporation, partnership, trust or other legal structure that does not have equity investors with substantive or proportional voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities.

At December 31, 2016, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

**Trust Preferred Securities**

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I (the "Trust"), which issued mandatorily redeemable preferred capital securities ("trust preferred securities") in 2003 in the aggregate of approximately \$7.0 million at the time of issuance. The Trust meets the definition of a VIE of which the Company is not the primary beneficiary; the Trust's only assets are junior subordinated debentures issued by the Company, which were acquired by the Trust using the proceeds from the issuance of the trust preferred securities and common stock.

In October 2016, the Company purchased \$4.0 million par amount of outstanding trust preferred securities issued by the Trust. These securities were sold by the FDIC, as receiver of a failed bank that had held the trust preferred securities. The Company used dividends from the Bank to purchase these trust preferred securities and has deemed an equivalent amount of the related junior subordinated debentures issued by the Company as no longer outstanding. The Company realized a pre-tax gain of \$0.8 million on the early extinguishment of debt in this transaction. The remaining junior subordinated debentures of approximately \$3.2 million are included in long-term debt and the Company's equity interest of \$0.2 million in the Trust is included in other assets. Interest expense on the junior subordinated debentures is included in interest expense on long-term debt.

The following table summarizes VIEs that are not consolidated by the Company as of December 31, 2016.

<i>(Dollars in thousands)</i>	<b>Maximum</b>	<b>Liability</b>	<b>Classification</b>
	<b>Loss Exposure</b>		
<b>Type:</b>			
Trust preferred issuances	N/A	\$ 3,217	Long-term debt

**NOTE 4: RESTRICTED CASH BALANCES**

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. As of December 31, 2016 and 2015, the Bank did not have a required reserve balance at the Federal Reserve Bank.

## NOTE 5: SECURITIES

At December 31, 2016 and 2015, respectively, all securities within the scope of ASC 320, *Investments – Debt and Equity Securities* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at December 31, 2016 and 2015, respectively, are presented below.

<i>(Dollars in thousands)</i>		1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized		Amortized Cost
							Gains	Losses	
<b>December 31, 2016</b>									
Agency obligations (a)	\$	3,047	22,531	19,893	—	45,471	331	973	\$ 46,113
Agency RMBS (a)		—	972	16,171	110,644	127,787	551	1,805	129,041
State and political subdivisions		—	2,480	10,210	57,624	70,314	1,509	734	69,539
Total available-for-sale	\$	3,047	25,983	46,274	168,268	243,572	2,391	3,512	\$ 244,693
<b>December 31, 2015</b>									
Agency obligations (a)	\$	5,000	25,852	19,463	9,770	60,085	384	518	\$ 60,219
Agency RMBS (a)		—	1,623	13,511	95,820	110,954	968	780	\$ 110,766
State and political subdivisions		—	497	12,094	58,057	70,648	3,022	7	\$ 67,633
Total available-for-sale	\$	5,000	27,972	45,068	163,647	241,687	4,374	1,305	\$ 238,618

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of \$137.2 million and \$133.3 million at December 31, 2016 and 2015, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (“FHLB”) advances, and for other purposes required or permitted by law.

Included in other assets on the accompanying consolidated balance sheets are cost-method investments. The carrying amounts of cost-method investments were \$1.4 million at December 31, 2016 and 2015, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (“FRB”) stock.

### Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at December 31, 2016 and 2015, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or more are presented below.

<i>(Dollars in thousands)</i>		Less than 12 Months		12 Months or Longer		Total	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>December 31, 2016:</b>							
Agency obligations	\$	20,352	973	—	—	20,352	\$ 973
Agency RMBS		89,062	1,805	—	—	89,062	1,805
State and political subdivisions		20,444	734	—	—	20,444	734
Total	\$	129,858	3,512	—	—	129,858	\$ 3,512
<b>December 31, 2015:</b>							
Agency obligations	\$	8,157	2	24,444	516	32,601	\$ 518
Agency RMBS		42,345	367	18,184	413	60,529	780
State and political subdivisions		267	1	969	6	1,236	7
Total	\$	50,769	370	43,597	935	94,366	\$ 1,305

For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. The Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities’ amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

In determining whether a loss is temporary, the Company considers all relevant information including:

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

#### *Agency obligations*

The unrealized losses associated with agency obligations were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

#### *Agency residential mortgage-backed securities ("RMBS")*

The unrealized losses associated with agency RMBS were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

#### *Securities of U.S. states and political subdivisions*

The unrealized losses associated with securities of U.S. states and political subdivisions were primarily driven by changes in interest rates and were not due to the credit quality of the securities. Some of these securities are guaranteed by a bond insurer, but management did not rely on the guarantee in making its investment decision. These securities will continue to be monitored as part of the Company's quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

#### *Cost-method investments*

At December 31, 2016, cost-method investments with an aggregate cost of \$1.4 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

The carrying values of the Company's investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that significant other-than-temporary impairment charges may occur in the future.

## Other-Than-Temporarily Impaired Securities

Credit-impaired debt securities are debt securities where the Company has written down the amortized cost basis of a security for other-than-temporary impairment and the credit component of the loss is recognized in earnings. At December 31, 2016 and 2015, respectively, the Company had no credit-impaired debt securities and there were no additions or reductions in the credit loss component of credit-impaired debt securities during the years ended December 31, 2016 and 2015, respectively.

## Realized Gains and Losses

The following table presents the gross realized gains and losses on sales related to securities.

<i>(Dollars in thousands)</i>	Year ended December 31	
	2016	2015
Gross realized gains	\$ 166	16
Gross realized losses	(387)	—
Realized (losses) gains, net	\$ (221)	16

## NOTE 6: LOANS AND ALLOWANCE FOR LOAN LOSSES

<i>(In thousands)</i>	December 31	
	2016	2015
Commercial and industrial	\$ 49,850	\$ 52,479
Construction and land development	41,650	43,694
Commercial real estate:		
Owner occupied	49,745	46,602
Multifamily	46,998	45,264
Other	123,696	111,987
Total commercial real estate	220,439	203,853
Residential real estate:		
Consumer mortgage	65,564	70,009
Investment property	45,291	46,664
Total residential real estate	110,855	116,673
Consumer installment	8,712	10,220
Total loans	431,506	426,919
Less: unearned income	(560)	(509)
Loans, net of unearned income	\$ 430,946	\$ 426,410

Loans secured by real estate were approximately 86.4% of the total loan portfolio at December 31, 2016. At December 31, 2016, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, *Receivables*, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. As part of the Company's quarterly assessment of the allowance, the loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate and consumer installment. Where appropriate, the Company's loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity's method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments.

*Commercial and industrial (“C&I”)* – includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower.

*Construction and land development (“C&D”)* – includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

*Commercial real estate (“CRE”)* – includes loans disaggregated into three classes: (1) owner occupied (2) multi-family and (3) other.

- *Owner occupied* – includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.
- *Multifamily* – primarily includes loans to finance income-producing multi-family properties. Loans in this class include loans for 5 or more unit residential property and apartments leased to residents. Generally, the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.
- *Other* – primarily includes loans to finance income-producing commercial properties. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, and warehouses leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates as well as the financial health of the borrower.

*Residential real estate (“RRE”)* – includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

- *Consumer mortgage* – primarily includes first or second lien mortgages and home equity lines to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank’s general loan policies and procedures which require, among other things, proper documentation of each borrower’s financial condition, satisfactory credit history and property value.
- *Investment property* – primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates as well as the financial health of the borrower.

*Consumer installment* – includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank’s general loan policies and procedures which require, among other things, proper documentation of each borrower’s financial condition, satisfactory credit history, and if applicable, property value.

The following is a summary of current, accruing past due and nonaccrual loans by portfolio class as of December 31, 2016 and 2015.

<i>(In thousands)</i>	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non- Accrual	Total Loans
<b>December 31, 2016:</b>						
Commercial and industrial	\$ 49,747	66	—	49,813	37	\$ 49,850
Construction and land development	41,223	395	—	41,618	32	41,650
Commercial real estate:						
Owner occupied	49,564	43	—	49,607	138	49,745
Multifamily	46,998	—	—	46,998	—	46,998
Other	121,608	199	—	121,807	1,889	123,696
Total commercial real estate	218,170	242	—	218,412	2,027	220,439
Residential real estate:						
Consumer mortgage	64,059	1,282	—	65,341	223	65,564
Investment property	45,243	19	—	45,262	29	45,291
Total residential real estate	109,302	1,301	—	110,603	252	110,855
Consumer installment	8,652	38	—	8,690	22	8,712
Total	\$ 427,094	2,042	—	429,136	2,370	\$ 431,506
<b>December 31, 2015:</b>						
Commercial and industrial	\$ 52,387	49	—	52,436	43	\$ 52,479
Construction and land development	43,111	—	—	43,111	583	43,694
Commercial real estate:						
Owner occupied	46,372	—	—	46,372	230	46,602
Multifamily	45,264	—	—	45,264	—	45,264
Other	110,467	—	—	110,467	1,520	111,987
Total commercial real estate	202,103	—	—	202,103	1,750	203,853
Residential real estate:						
Consumer mortgage	68,579	1,105	—	69,684	325	70,009
Investment property	46,435	229	—	46,664	—	46,664
Total residential real estate	115,014	1,334	—	116,348	325	116,673
Consumer installment	10,179	28	—	10,207	13	10,220
Total	\$ 422,794	1,411	—	424,205	2,714	\$ 426,919

The gross interest income which would have been recorded under the original terms of those nonaccrual loans had they been accruing interest, amounted to approximately \$107 thousand and \$133 thousand for the years ended December 31, 2016 and 2015, respectively.

**Allowance for Loan Losses**

The allowance for loan losses as of and for the years ended December 31, 2016 and 2015, is presented below.

<i>(In thousands)</i>	Year ended December 31	
	2016	2015
Beginning balance	\$ 4,289	\$ 4,836
Charged-off loans	(540)	(1,114)
Recovery of previously charged-off loans	1,379	367
Net charge-offs	839	(747)
Provision for loan losses	(485)	200
Ending balance	\$ 4,643	\$ 4,289

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a "confirming event" has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal, independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company's loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

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The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2016 and 2015, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several "qualitative and environmental" factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. Beginning with the quarter ended December 31, 2016, the Company implemented certain refinements to its allowance for loan losses methodology in order to better capture the effects of the most recent economic cycle on the Company's loan loss experience. First, the Company increased its look-back period for calculating average losses for all loan segments to 31 quarters. Prior to December 31, 2016, the Company calculated average losses for all loan segments using a rolling 20 quarter look-back period. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. Second, the Company increased the range of basis point adjustments allowed for qualitative and environmental factors to approximately 200 basis points, an increase of 65 basis points, or 48%, compared to the 135 basis point range used prior to December 31, 2016. After performing sensitivity testing of its calculation of the allowance for loan losses, the Company determined that it should increase the range of basis points allowed for qualitative and environmental factors in order to provide sufficient latitude in determining estimated probable credit losses during periods of economic stress. Third, the Company reduced the percentage allocation for qualitative and environmental factors on a weighted average basis to 21% of total basis points allocable at December 31, 2016, compared to 25% of total basis points allocable at September 30, 2016. The Company believes a decrease in the percentage allocation of qualitative environmental factors on a weighted average basis was appropriate due to the extension of its look-back period described above. If the Company did not make the changes described above, the Company's calculated allowance for loan loss allocation would have decreased by approximately \$0.9 million, or 0.21% of total loans, at December 31, 2016. Other than the changes discussed above, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

The following table details the changes in the allowance for loan losses by portfolio segment for the years ended December 31, 2016 and 2015.

<i>(in thousands)</i>	Commercial and industrial	Construction and land Development	Commercial Real Estate	Residential Real Estate	Consumer Installment	Total
<b>Balance, December 31, 2014</b>	\$ 639	974	1,928	1,119	176	\$ 4,836
Charge-offs	(100)	—	(866)	(89)	(59)	(1,114)
Recoveries	22	17	—	313	15	367
Net (charge-offs) recoveries	(78)	17	(866)	224	(44)	(747)
Provision	(38)	(322)	817	(284)	27	200
<b>Balance, December 31, 2015</b>	\$ 523	669	1,879	1,059	159	\$ 4,289
Charge-offs	(97)	—	(194)	(182)	(67)	(540)
Recoveries	29	1,212	—	127	11	1,379
Net (charge-offs) recoveries	(68)	1,212	(194)	(55)	(56)	839
Provision	85	(1,069)	386	103	10	(485)
<b>Balance, December 31, 2016</b>	\$ 540	812	2,071	1,107	113	\$ 4,643

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of December 31, 2016 and 2015.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
<i>(In thousands)</i>						
<b>December 31, 2016:</b>						
Commercial and industrial	\$ 540	49,835	—	15	540	49,850
Construction and land development	812	41,618	—	32	812	41,650
Commercial real estate	2,040	218,356	31	2,083	2,071	220,439
Residential real estate	1,107	110,855	—	—	1,107	110,855
Consumer installment	113	8,712	—	—	113	8,712
Total	\$ 4,612	429,376	31	2,130	4,643	431,506
<b>December 31, 2015:</b>						
Commercial and industrial	\$ 523	52,431	—	48	523	52,479
Construction and land development	669	43,111	—	583	669	43,694
Commercial real estate	1,758	201,077	121	2,776	1,879	203,853
Residential real estate	1,059	116,673	—	—	1,059	116,673
Consumer installment	159	10,220	—	—	159	10,220
Total	\$ 4,168	423,512	121	3,407	4,289	426,919

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans.

(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

## Credit Quality Indicators

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for qualitative and environmental factors and are defined as follows:

- Pass – loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.
- Special Mention – loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company's position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.
- Substandard Accruing – loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected.
- Nonaccrual – includes loans where management has determined that full payment of principal and interest is in doubt.

<i>(In thousands)</i>	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
<b>December 31, 2016</b>					
Commercial and industrial	\$ 49,558	22	233	37	\$ 49,850
Construction and land development	41,165	113	340	32	41,650
Commercial real estate:					
Owner occupied	48,788	414	405	138	49,745
Multifamily	46,998	—	—	—	46,998
Other	121,326	32	449	1,889	123,696
Total commercial real estate	217,112	446	854	2,027	220,439
Residential real estate:					
Consumer mortgage	59,450	2,613	3,278	223	65,564
Investment property	44,109	105	1,048	29	45,291
Total residential real estate	103,559	2,718	4,326	252	110,855
Consumer installment	8,580	20	90	22	8,712
<b>Total</b>	<b>\$ 419,974</b>	<b>3,319</b>	<b>5,843</b>	<b>2,370</b>	<b>\$ 431,506</b>
<b>December 31, 2015</b>					
Commercial and industrial	\$ 48,038	4,075	323	43	\$ 52,479
Construction and land development	42,458	60	593	583	43,694
Commercial real estate:					
Owner occupied	45,772	381	219	230	46,602
Multifamily	45,264	—	—	—	45,264
Other	110,159	36	272	1,520	111,987
Total commercial real estate	201,195	417	491	1,750	203,853
Residential real estate:					
Consumer mortgage	64,502	1,964	3,218	325	70,009
Investment property	45,399	112	1,153	—	46,664
Total residential real estate	109,901	2,076	4,371	325	116,673
Consumer installment	10,038	55	114	13	10,220
<b>Total</b>	<b>\$ 411,630</b>	<b>6,683</b>	<b>5,892</b>	<b>2,714</b>	<b>\$ 426,919</b>

**Impaired loans**

The following table presents details related to the Company's impaired loans. Loans which have been fully charged-off do not appear in the following table. The related allowance generally represents the following components which correspond to impaired loans:

- Individually evaluated impaired loans equal to or greater than \$500 thousand secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate).
- Individually evaluated impaired loans equal to or greater than \$250 thousand not secured by real estate (nonaccrual commercial and industrial and consumer loans).

The following table sets forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at December 31, 2016 and 2015.

<i>(In thousands)</i>	<b>December 31, 2016</b>			
	<b>Unpaid principal balance (1)</b>	<b>Charge-offs and payments applied (2)</b>	<b>Recorded investment (3)</b>	<b>Related allowance</b>
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 15	—	15	
Construction and land development	140	(108)	32	
Commercial real estate:				
Other	2,874	(984)	1,890	
Total commercial real estate	2,874	(984)	1,890	
<b>Total</b>	<b>\$ 3,029</b>	<b>(1,092)</b>	<b>1,937</b>	
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied	193	—	193	31
Total commercial real estate	193	—	193	31
<b>Total</b>	<b>\$ 193</b>	<b>—</b>	<b>193</b>	<b>\$ 31</b>
<b>Total impaired loans</b>	<b>\$ 3,222</b>	<b>(1,092)</b>	<b>2,130</b>	<b>\$ 31</b>

(1) Unpaid principal balance represents the contractual obligation due from the customer.

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.

(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

	December 31, 2015			
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
<i>(In thousands)</i>				
<b>With no allowance recorded:</b>				
Commercial and industrial	\$ 48	—	48	
Construction and land development	2,582	(1,999)	583	
Commercial real estate:				
Owner occupied	308	(78)	230	
Other	2,136	(617)	1,519	
Total commercial real estate	2,444	(695)	1,749	
Total	\$ 5,074	(2,694)	2,380	
<b>With allowance recorded:</b>				
Commercial real estate:				
Owner occupied	\$ 1,027	—	1,027	\$ 121
Total commercial real estate	1,027	—	1,027	121
Total	\$ 1,027	—	1,027	\$ 121
<b>Total impaired loans</b>	<b>\$ 6,101</b>	<b>(2,694)</b>	<b>3,407</b>	<b>\$ 121</b>

(1) Unpaid principal balance represents the contractual obligation due from the customer.

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.

(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

	Year ended December 31, 2016		Year ended December 31, 2015	
	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
<i>(In thousands)</i>				
<b>Impaired loans:</b>				
Commercial and industrial	\$ 31	2	\$ 60	4
Construction and land development	94	—	603	—
Commercial real estate:				
Owner occupied	699	31	1,328	62
Other	1,687	—	911	18
Total commercial real estate	2,386	31	2,239	80
Residential real estate:				
Consumer mortgages	—	—	349	173
Investment property	—	—	70	76
Total residential real estate	—	—	419	249
Total	\$ 2,511	33	\$ 3,321	333

Interest income recognized for 2015 included interest recoveries of \$225 thousand related to two impaired residential real estate loans that paid off in June 2015. Excluding the interest recoveries on these two loans, interest income recognized on impaired loans for 2015 would have been \$108 thousand.

**Troubled Debt Restructurings**

Impaired loans also include troubled debt restructurings (“TDRs”). In the normal course of business, management may grant concessions to borrowers who are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. In determining whether a loan modification is a TDR, the Company considers the individual facts and circumstances surrounding each modification. In determining the appropriate accrual status at the time of restructure, the Company evaluates whether a restructured loan has adequate collateral protection, among other factors.

Similar to other impaired loans, TDRs are measured for impairment based on the present value of expected payments using the loan’s original effective interest rate as the discount rate, or the fair value of the collateral, less selling costs if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, impairment is recognized by establishing a valuation allowance as part of the allowance for loan losses or a charge-off to the allowance for loan losses. In periods subsequent to the modification, all TDRs are evaluated individually, including those that have payment defaults, for possible impairment.

The following is a summary of accruing and nonaccrual TDRs and the related loan losses, by portfolio segment and class.

<i>(In thousands)</i>	<b>TDRs</b>			<b>Related Allowance</b>
	<b>Accruing</b>	<b>Nonaccrual</b>	<b>Total</b>	
<b>December 31, 2016</b>				
Commercial and industrial	\$ 15	—	15	\$ —
Construction and land development	—	32	32	—
Commercial real estate:				
Owner occupied	193	—	193	31
Other	—	1,818	1,818	—
Total commercial real estate	193	1,818	2,011	31
Total	\$ 208	1,850	2,058	\$ 31
<b>December 31, 2015</b>				
Commercial and industrial	\$ 48	—	48	\$ —
Construction and land development	—	582	582	—
Commercial real estate:				
Owner occupied	1,027	230	1,257	121
Total commercial real estate	1,027	230	1,257	121
Total	\$ 1,075	812	1,887	\$ 121

At December 31, 2016, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

The following table summarizes loans modified in a TDR during the respective years both before and after modification.

<i>(\$ in thousands)</i>	Number of contracts		Pre- modification outstanding recorded investment	Post- modification outstanding recorded investment
<b>December 31, 2016</b>				
Commercial real estate:				
Other	3	\$	3,147	3,137
Total commercial real estate	3		3,147	3,137
Total	3	\$	3,147	3,137
<b>December 31, 2015</b>				
Commercial and industrial	1	\$	61	66
Construction and land development	1		116	113
Commercial real estate:				
Owner occupied	1		216	218
Other	1		592	592
Total commercial real estate	2		808	810
Total	4	\$	985	989

The majority of the loans modified in a TDR during the years ended December 31, 2016 and 2015, respectively, included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate.

The Company had no TDRs with a payment default during 2016. The following table summarizes the recorded investment in loans modified in a TDR within the previous twelve months for which there was a payment default (defined as 90 days or more past due) during 2015.

<i>(\$ in thousands)</i>	Number of Contracts		Recorded investment (1)
<b>December 31, 2015</b>			
Commercial real estate:			
Owner occupied		1	\$ 262
Total commercial real estate		1	262
Residential real estate:			
Investment property		1	150
Total residential real estate		1	150
Total		2	\$ 412

(1) Amount as of applicable month end during the respective year for which there was a payment default.

## NOTE 7: PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2016 and 2015 is presented below.

<i>(Dollars in thousands)</i>	December 31	
	2016	2015
Land	\$ 7,231	6,106
Buildings and improvements	9,478	9,448
Furniture, fixtures, and equipment	3,210	3,159
Total premises and equipment	19,919	18,713
Less: accumulated depreciation	(7,317)	(6,847)
Premises and equipment, net	\$ 12,602	11,866

Depreciation expense was approximately \$470 thousand and \$475 thousand for the years ended December 31, 2016 and 2015, respectively, and is a component of net occupancy and equipment expense in the consolidated statements of earnings.

**NOTE 8: MORTGAGE SERVICING RIGHTS, NET**

Mortgage servicing rights (“MSRs”) are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the Company’s MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income. Servicing fee income is recorded net of related amortization expense and recognized in earnings as part of mortgage lending income.

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSRs are included in other assets on the accompanying consolidated balance sheets.

The Company evaluates MSRs for impairment on a quarterly basis. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

The following table details the changes in amortized MSRs and the related valuation allowance for the years ended December 31, 2016 and 2015.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
Beginning balance	\$ 2,316	2,388
Additions, net	324	529
Amortization expense	(687)	(654)
Change in valuation allowance	(1)	53
Ending balance	\$ 1,952	2,316

**Valuation allowance included in MSRs, net:**

Beginning of period	\$ —	53
End of period	1	—

**Fair value of amortized MSRs:**

Beginning of period	\$ 3,086	3,238
End of period	2,678	3,086

Data and assumptions used in the fair value calculation related to MSRs at December 31, 2016 and 2015, respectively, are presented below.

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
Unpaid principal balance	\$ 338,434	358,928
Weighted average prepayment speed (CPR)	10.9 %	10.0
Discount rate (annual percentage)	10.0 %	10.0
Weighted average coupon interest rate	3.8 %	3.9
Weighted average remaining maturity (months)	257	266
Weighted average servicing fee (basis points)	25.0	25.0

At December 31, 2016, the weighted average amortization period for MSRs was 5.9 years. Estimated amortization expense for each of the next five years is presented below.

<i>(Dollars in thousands)</i>	<b>December 31, 2016</b>
2017	\$ 424
2018	356
2019	301
2020	255
2021	215

#### **NOTE 9: DEPOSITS**

At December 31, 2016, the scheduled maturities of certificates of deposit and other time deposits are presented below.

<i>(Dollars in thousands)</i>	<b>December 31, 2016</b>
2017	\$ 110,428
2018	43,311
2019	37,817
2020	9,347
2021	7,234
Total certificates of deposit and other time deposits	\$ 208,137

Additionally, at December 31, 2016 and 2015, approximately \$59.5 million and \$59.6 million, respectively, of certificates of deposit and other time deposits were issued in denominations of \$250 thousand or greater.

At December 31, 2016 and 2015, the amount of deposit accounts in overdraft status that were reclassified to loans on the accompanying consolidated balance sheets was not material.

#### **NOTE 10: SHORT-TERM BORROWINGS**

At December 31, 2016 and 2015, the composition of short-term borrowings is presented below.

<i>(Dollars in thousands)</i>	<u>2016</u>		<u>2015</u>	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
<b>Federal funds purchased:</b>				
As of December 31	\$ —	—	\$ —	—
Average during the year	14	1.21 %	16	0.90 %
Maximum outstanding at any month-end	—		—	
<b>Securities sold under agreements to repurchase:</b>				
As of December 31	\$ 3,366	0.50 %	\$ 2,951	0.50 %
Average during the year	2,969	0.50 %	3,585	0.50 %
Maximum outstanding at any month-end	3,507		4,806	

Federal funds purchased represent unsecured overnight borrowings from other financial institutions by the Bank. The Bank had available federal fund lines totaling \$41.0 million with none outstanding at December 31, 2016.

Securities sold under agreements to repurchase represent short-term borrowings with maturities less than one year collateralized by a portion of the Company's securities portfolio. Securities with an aggregate carrying value of \$6.0 million and \$6.3 million at December 31, 2016 and 2015, respectively, were pledged to secure securities sold under agreements to repurchase.

**NOTE 11: LONG-TERM DEBT**

At December 31, 2016 and 2015, the composition of long-term debt is presented below.

<i>(Dollars in thousands)</i>	2016		2015	
	Amount	Weighted Avg. Rate	Amount	Weighted Avg. Rate
Subordinated debentures, due 2033	\$ 3,217	3.88%	\$ 7,217	3.63%
Total long-term debt	\$ 3,217	3.88%	\$ 7,217	3.63%

The Company formed Auburn National Bancorporation Capital Trust I (the "Trust"), a wholly-owned statutory business trust, in 2003. The Trust issued \$7.0 million of trust preferred securities that were sold to third parties. The proceeds from the sale of the trust preferred securities and trust common securities that we hold, were used to purchase junior subordinated debentures of \$7.2 million from the Company, which are presented as long-term debt in the consolidated balance sheets and qualify for inclusion in Tier 1 capital for regulatory capital purposes, subject to certain limitations. The debentures mature on December 31, 2033 and have been redeemable since December 31, 2008.

In October 2016, the Company purchased \$4.0 million par amount of outstanding trust preferred securities issued by the Trust. These securities were sold by the FDIC, as receiver of a failed bank that held the trust preferred securities. The Company used dividends from the Bank to purchase these trust preferred securities and has deemed an equivalent amount of the related subordinated debentures issued by the company as no longer outstanding. The Company realized a pre-tax gain of \$0.8 million on the early extinguishment of debt in this transaction. Following the transaction, the Company had \$3.2 million in junior subordinated debentures related to \$3.0 million of trust preferred securities outstanding. The amount related to the trust preferred securities remains included in the Company's Tier 1 capital for regulatory purposes.

The following is a schedule of contractual maturities of long-term debt:

<i>(Dollars in thousands)</i>	2017	2018	2019	2020	2021	Thereafter	Total
Subordinated debentures	—	—	—	—	—	3,217	3,217
Total long-term debt	\$ —	—	—	—	—	3,217	3,217

**NOTE 12: OTHER COMPREHENSIVE INCOME (LOSS)**

Comprehensive income is defined as the change in equity from all transactions other than those with stockholders, and it includes net earnings and other comprehensive income (loss). Other comprehensive income (loss) for the years ended December 31, 2016 and 2015, is presented below.

<i>(In thousands)</i>	Pre-tax amount	Tax benefit (expense)	Net of tax amount
<b>2016:</b>			
Unrealized net holding loss on all other securities	\$ (4,412)	1,628	(2,784)
Reclassification adjustment for net loss on securities recognized in net earnings	221	(82)	139
Other comprehensive loss	\$ (4,191)	1,546	(2,645)
<b>2015:</b>			
Unrealized net holding loss on all other securities	\$ (785)	289	(496)
Reclassification adjustment for net gain on securities recognized in net earnings	(16)	6	(10)
Other comprehensive loss	\$ (801)	295	(506)

**NOTE 13: INCOME TAXES**

For the years ended December 31, 2016 and 2015 the components of income tax expense from continuing operations are presented below.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
Current income tax expense:		
Federal	\$ 2,143	1,805
State	498	395
Total current income tax expense	2,641	2,200
Deferred income tax expense (benefit):		
Federal	464	586
State	(3)	34
Total deferred income tax expense	461	620
Total income tax expense	\$ 3,102	2,820

Total income tax expense differs from the amounts computed by applying the statutory federal income tax rate of 34% to earnings before income taxes. A reconciliation of the differences for the years ended December 31, 2016 and 2015, is presented below.

<i>(Dollars in thousands)</i>	<b>2016</b>		<b>2015</b>	
	<b>Amount</b>	<b>Percent of pre-tax earnings</b>	<b>Amount</b>	<b>Percent of pre-tax earnings</b>
Earnings before income taxes	\$ 11,252		10,678	
Income taxes at statutory rate	3,826	34.0 %	3,631	34.0 %
Tax-exempt interest	(857)	(7.6)	(873)	(8.1)
State income taxes, net of federal tax effect	325	2.9	280	2.6
Bank-owned life insurance	(155)	(1.4)	(254)	(2.4)
Other	(37)	(0.3)	36	0.3
Total income tax expense	\$ 3,102	27.6 %	2,820	26.4 %

The Company had net deferred tax assets of \$1.3 million and \$0.2 million at December 31, 2016 and 2015, respectively, included in other assets on the consolidated balance sheets. The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2016 and 2015 are presented below:

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Deferred tax assets:</b>		
Allowance for loan losses	\$ 1,713	1,583
Unrealized loss on securities	414	—
Write-downs on other real estate owned	—	20
Tax credit carry-forwards	—	484
Other	316	519
Total deferred tax assets	2,443	2,606
<b>Deferred tax liabilities:</b>		
Premises and equipment	205	219
Unrealized gain on securities	—	1,132
Originated mortgage servicing rights	721	855
Other	237	205
Total deferred tax liabilities	1,163	2,411
Net deferred tax asset	\$ 1,280	195

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion of the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projection for future taxable income over the periods which the temporary differences resulting in the remaining deferred tax assets are deductible, management believes it is more-likely-than-not that the Company will realize the benefits of these deductible differences at December 31, 2016. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

The change in the net deferred tax asset for the years ended December 31, 2016 and 2015, is presented below.

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Net deferred tax asset:</b>		
Balance, beginning of year	\$ 195	519
Deferred tax expense related to continuing operations	(461)	(620)
Stockholders' equity, for accumulated other comprehensive loss	1,546	296
Balance, end of year	\$ 1,280	195

ASC 740, *Income Taxes*, defines the threshold for recognizing the benefits of tax return positions in the financial statements as “more-likely-than-not” to be sustained by the taxing authority. This section also provides guidance on the de-recognition, measurement, and classification of income tax uncertainties in interim periods. As of December 31, 2016, the Company had no unrecognized tax benefits related to federal or state income tax matters. The Company does not anticipate any material increase or decrease in unrecognized tax benefits during 2017 relative to any tax positions taken prior to December 31, 2016. As of December 31, 2016, the Company has accrued no interest and no penalties related to uncertain tax positions. It is the Company’s policy to recognize interest and penalties related to income tax matters in income tax expense.

The Company and its subsidiaries file consolidated U.S. federal and State of Alabama income tax returns. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service and the State of Alabama for the years ended December 31, 2013 through 2016.

#### NOTE 14: EMPLOYEE BENEFIT PLAN

The Company has a 401(k) Plan that covers substantially all employees. Participants may contribute up to 10% of eligible compensation subject to certain limits based on federal tax laws. The Company's matching contributions to the Plan are determined by the board of directors. Participants become 20% vested in their accounts after two years of service and 100% vested after six years of service. Company matching contributions to the Plan were \$124 thousand and \$116 thousand for the years ended December 31, 2016 and 2015, respectively, and are included in salaries and benefits expense.

#### NOTE 15: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying consolidated balance sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings within other noninterest income on the accompanying consolidated statements of earnings. From time to time, the Company may enter into interest rate swaps ("swaps") to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2016 and December 31, 2015, the Company had no derivative contracts to assist in managing its own interest rate sensitivity.

Interest rate swap agreements involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

A summary of the Company's interest rate swaps as of and for the years ended December 31, 2016 and 2015 is presented below.

	Notional	Other	Other	Other
		Assets	Liabilities	noninterest
		Estimated	Estimated	income
		Fair Value	Fair Value	Gains
				(Losses)
<i>(Dollars in thousands)</i>				
<b>December 31, 2016:</b>				
Pay fixed / receive variable	\$ 3,967	—	241	\$ 199
Pay variable / receive fixed	3,967	241	—	(199)
Total interest rate swap agreements	\$ 7,934	241	241	\$ —
<b>December 31, 2015:</b>				
Pay fixed / receive variable	\$ 4,317	—	440	\$ 194
Pay variable / receive fixed	4,317	440	—	(194)
Total interest rate swap agreements	\$ 8,634	440	440	\$ —

#### NOTE 16: COMMITMENTS AND CONTINGENT LIABILITIES

##### Credit-Related Financial Instruments

The Company is party to credit related financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance sheet instruments.

At December 31, 2016 and 2015, the following financial instruments were outstanding whose contract amount represents credit risk:

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
Commitments to extend credit	\$ 45,979	\$ 52,230
Standby letters of credit	7,432	8,221

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines of credit may expire without being drawn upon. Therefore, total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Company, is based on management's credit evaluation of the customer.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds various assets as collateral, including accounts receivable, inventory, equipment, marketable securities, and property to support those commitments for which collateral is deemed necessary. The Company has recorded a liability for the estimated fair value of these standby letters of credit in the amount of \$84 thousand and \$69 thousand at December 31, 2016 and 2015, respectively.

#### ***Other Commitments***

Minimum lease payments under leases classified as operating leases due in each of the five years subsequent to December 31, 2016, are as follows: 2017, \$155 thousand; 2018, \$51 thousand; 2019, \$36 thousand; 2020, \$3 thousand; 2021, none.

#### ***Contingent Liabilities***

The Company and the Bank are involved in various legal proceedings, arising in connection with their business. In the opinion of management, based upon consultation with legal counsel, the ultimate resolution of these proceeding will not have a material adverse effect upon the consolidated financial condition or results of operations of the Company and the Bank.

### **NOTE 17: FAIR VALUE**

#### **Fair Value Hierarchy**

"Fair value" is defined by ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1—inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets.

Level 2—inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3—inputs to the valuation methodology are unobservable and reflect the Company's own assumptions about the inputs market participants would use in pricing the asset or liability.

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## **Level changes in fair value measurements**

Transfers between levels of the fair value hierarchy are generally recognized at the end of the reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company's financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the years ended December 31, 2016 and 2015, there were no transfers between levels and no changes in valuation techniques for the Company's financial assets and liabilities.

## **Assets and liabilities measured at fair value on a recurring basis**

### *Securities available-for-sale*

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may include broker/dealer quotes, market spreads, cash flows, market consensus prepayment speeds, benchmark yields, reported trades for similar securities, credit information and the securities' terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

### *Interest rate swap agreements*

The carrying amount of interest rate swap agreements was included in other assets and accrued expenses and other liabilities on the accompanying consolidated balance sheets. The fair value measurements for our interest rate swap agreements were based on information obtained from a third party bank. This information is periodically tested by the Company and validated against other third party valuations. If needed, other third party market participants may be utilized to corroborate the fair value measurements for our interest rate swap agreements. The Company classified these derivative assets and liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2016 and 2015, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

<i>(Dollars in thousands)</i>	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>December 31, 2016:</b>				
Securities available-for-sale:				
Agency obligations	\$ 45,471	—	45,471	—
Agency RMBS	127,787	—	127,787	—
State and political subdivisions	70,314	—	70,314	—
Total securities available-for-sale	243,572	—	243,572	—
Other assets <sup>(1)</sup>	241	—	241	—
<b>Total assets at fair value</b>	<b>\$ 243,813</b>	<b>—</b>	<b>243,813</b>	<b>—</b>
Other liabilities <sup>(1)</sup>				
	241	—	241	—
<b>Total liabilities at fair value</b>	<b>\$ 241</b>	<b>—</b>	<b>241</b>	<b>—</b>
<b>December 31, 2015:</b>				
Securities available-for-sale:				
Agency obligations	\$ 60,085	—	60,085	—
Agency RMBS	110,954	—	110,954	—
State and political subdivisions	70,648	—	70,648	—
Total securities available-for-sale	241,687	—	241,687	—
Other assets <sup>(1)</sup>	440	—	440	—
<b>Total assets at fair value</b>	<b>\$ 242,127</b>	<b>—</b>	<b>242,127</b>	<b>—</b>
Other liabilities <sup>(1)</sup>				
	440	—	440	—
<b>Total liabilities at fair value</b>	<b>\$ 440</b>	<b>—</b>	<b>440</b>	<b>—</b>

<sup>(1)</sup>Represents the fair value of interest rate swap agreements.

#### Assets and liabilities measured at fair value on a nonrecurring basis

##### *Loans held for sale*

Loans held for sale are carried at the lower of cost or fair value. Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans. Loans held for sale are classified within Level 2 of the fair value hierarchy.

##### *Impaired Loans*

Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent.

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The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

*Other real estate owned*

Other real estate owned, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan's carrying amount or the fair value less costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, a loss is recognized in noninterest expense.

*Mortgage servicing rights, net*

Mortgage servicing rights, net, included in other assets on the accompanying consolidated balance sheets, are carried at the lower of cost or estimated fair value. MSR's do not trade in an active market with readily observable prices. To determine the fair value of MSR's, the Company engages an independent third party. The independent third party's valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Periodically, the Company will review broker surveys and other market research to validate significant assumptions used in the model. The significant unobservable inputs include prepayment speeds or the constant prepayment rate ("CPR") and the weighted average discount rate. Because the valuation of MSR's requires the use of significant unobservable inputs, all of the Company's MSR's are classified within Level 3 of the valuation hierarchy.

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2016 and 2015, respectively, by caption, on the accompanying consolidated balance sheets and by ASC 820 valuation hierarchy (as described above):

<i>(Dollars in thousands)</i>	<b>Amount</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
<b>December 31, 2016:</b>				
Loans held for sale	\$ 1,497	—	1,497	—
Loans, net <sup>(1)</sup>	2,099	—	—	2,099
Other real estate owned	152	—	—	152
Other assets <sup>(2)</sup>	1,952	—	—	1,952
<b>Total assets at fair value</b>	<b>\$ 5,700</b>	<b>—</b>	<b>1,497</b>	<b>4,203</b>
<b>December 31, 2015:</b>				
Loans held for sale	\$ 1,540	—	1,540	—
Loans, net <sup>(1)</sup>	3,286	—	—	3,286
Other real estate owned	252	—	—	252
Other assets <sup>(2)</sup>	2,316	—	—	2,316
<b>Total assets at fair value</b>	<b>\$ 7,394</b>	<b>—</b>	<b>1,540</b>	<b>5,854</b>

<sup>(1)</sup>Loans considered impaired under ASC 310-10-35 Receivables. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.

<sup>(2)</sup>Represents MSRs, net, carried at lower of cost or estimated fair value.

At December 31, 2016 and 2015 and for the years then ended, the Company had no Level 3 assets measured at fair value on a recurring basis. For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2016, the significant unobservable inputs used in the fair value measurements are presented below.

<i>(Dollars in thousands)</i>	<b>Carrying Amount</b>	<b>Valuation Technique</b>	<b>Significant Unobservable Input</b>	<b>Weighted Average of Input</b>
<b>Nonrecurring:</b>				
Impaired loans	\$ 2,099	Appraisal	Appraisal discounts (%)	45.2%
Other real estate owned	152	Appraisal	Appraisal discounts (%)	10.0%
Mortgage servicing rights, net	1,952	Discounted cash flow	Prepayment speed or CPR (%) Discount rate (%)	10.9% 10.0%

### Fair Value of Financial Instruments

ASC 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow analyses. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company's financial instruments, but rather are a good-faith estimate of the fair value of financial instruments held by the Company. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

***Loans, net***

Fair values for loans were calculated using discounted cash flows. The discount rates reflected current rates at which similar loans would be made for the same remaining maturities. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820 and generally produces a higher value than an exit-price approach. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

***Loans held for sale***

Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans.

***Time Deposits***

Fair values for time deposits were estimated using discounted cash flows. The discount rates were based on rates currently offered for deposits with similar remaining maturities.

***Long-term debt***

The fair value of the Company's fixed rate long-term debt is estimated using discounted cash flows based on estimated current market rates for similar types of borrowing arrangements. The carrying amount of the Company's variable rate long-term debt approximates its fair value.

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company's financial instruments at December 31, 2016 and 2015 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand, interest-bearing demand, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

	Carrying amount	Estimated fair value	Fair Value Hierarchy		
			Level 1 inputs	Level 2 inputs	Level 3 Inputs
<i>(Dollars in thousands)</i>					
<b>December 31, 2016:</b>					
Financial Assets:					
Loans, net (1)	\$ 426,303	\$ 428,446	\$ —	\$ —	\$ 428,446
Loans held for sale	1,497	1,507	—	1,507	—
Financial Liabilities:					
Time Deposits	\$ 208,137	\$ 207,791	\$ —	\$ 207,791	\$ —
Long-term debt	3,217	3,217	—	3,217	—
<b>December 31, 2015:</b>					
Financial Assets:					
Loans, net (1)	\$ 422,121	\$ 427,340	\$ —	\$ —	\$ 427,340
Loans held for sale	1,540	1,574	—	1,574	—
Financial Liabilities:					
Time Deposits	\$ 219,598	\$ 220,093	\$ —	\$ 220,093	\$ —
Long-term debt	7,217	7,217	—	7,217	—

(1) Represents loans, net of unearned income and the allowance for loan losses.

**NOTE 18: RELATED PARTY TRANSACTIONS**

A former director who retired from the Company's board of directors in October 2015, was an officer in a construction company that the Company contracted with in 2015 for the build out of leasehold improvements in connection with a relocation of a bank branch and for construction of a new branch facility located in Auburn, Alabama. Total payments made to the construction company under the terms of these contracts were \$1.2 million for the year ended December 31, 2015. There were no payments made related to these contracts for the year ended December 31, 2016.

The Bank has made, and expects in the future to continue to make in the ordinary course of business, loans to directors and executive officers of the Company, the Bank, and their affiliates. In management's opinion, these loans were made in the ordinary course of business at normal credit terms, including interest rate and collateral requirements, and do not represent more than normal credit risk. An analysis of such outstanding loans is presented below.

<i>(Dollars in thousands)</i>	<b>Amount</b>
Loans outstanding at December 31, 2015	\$ 3,715
New loans/advances	1,071
Repayments	(866)
Changes in directors and executive officers	24
Loans outstanding at December 31, 2016	\$ 3,944

During 2016 and 2015, certain executive officers and directors of the Company and the Bank, including companies with which they are affiliated, were deposit customers of the bank. Total deposits for these persons at December 31, 2016 and 2015 amounted to \$17.8 million and \$18.1 million, respectively.

**NOTE 19: REGULATORY RESTRICTIONS AND CAPITAL RATIOS**

The Company and the Bank are subject to various regulatory capital requirements and policies administered by federal and State of Alabama banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors, including anticipated capital needs. Supervisory assessments of capital adequacy may differ significantly from conclusions based solely upon risk-based capital ratios. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) common equity Tier 1 ratio, Tier 1 leverage ratio, Tier 1 risk-based ratio and total risk-based ratio. Management believes, as of December 31, 2016, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2016, the Bank is "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Bank must maintain minimum common equity Tier 1, total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. Management has not received any notification from the Company's or the Bank's regulators that changes the Bank's regulatory capital status.

The actual capital amounts and ratios and the aforementioned minimums as of December 31, 2016 and 2015 are presented below.

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>						
<b>At December 31, 2016:</b>						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 85,480	10.27 %	\$ 33,293	4.00 %	N/A	N/A
AuburnBank	84,287	10.14	33,259	4.00	\$ 41,574	5.00 %
Common Equity Tier 1 Capital						
Auburn National Bancorporation	\$ 82,642	16.44 %	\$ 22,621	4.50 %	N/A	N/A
AuburnBank	84,287	16.74	22,663	4.50	\$ 32,736	6.50
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 85,480	17.00 %	\$ 30,162	6.00 %	N/A	N/A
AuburnBank	84,287	16.74	30,218	6.00	\$ 40,290	8.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 90,254	17.95 %	\$ 40,216	8.00 %	N/A	N/A
AuburnBank	89,061	17.68	40,290	8.00	\$ 50,363	10.00 %
<b>At December 31, 2015:</b>						
Tier 1 Leverage Capital						
Auburn National Bancorporation	\$ 84,268	10.35 %	\$ 32,553	4.00 %	N/A	N/A
AuburnBank	82,848	10.19	32,519	4.00	\$ 40,649	5.00 %
Common Equity Tier 1 Capital						
Auburn National Bancorporation	\$ 77,714	15.28 %	\$ 22,886	4.50 %	N/A	N/A
AuburnBank	82,848	16.26	22,933	4.50	\$ 33,125	6.50
Tier 1 Risk-Based Capital						
Auburn National Bancorporation	\$ 84,268	16.57 %	\$ 30,515	6.00 %	N/A	N/A
AuburnBank	82,848	16.26	30,577	6.00	\$ 40,769	8.00 %
Total Risk-Based Capital						
Auburn National Bancorporation	\$ 88,682	17.44 %	\$ 40,687	8.00 %	N/A	N/A
AuburnBank	87,262	17.12	40,769	8.00	\$ 50,962	10.00 %

Dividends paid by the Bank are a principal source of funds available to the Company for payment of dividends to its stockholders and for other needs. Applicable federal and state statutes and regulations impose restrictions on the amounts of dividends that may be declared by the subsidiary bank. State law and Federal Reserve policy restrict the Bank from declaring dividends in excess of the sum of the current year's earnings plus the retained net earnings from the preceding two years without prior approval. In addition to the formal statutes and regulations, regulatory authorities also consider the adequacy of the Bank's total capital in relation to its assets, deposits, and other such items. Capital adequacy considerations could further limit the availability of dividends from the Bank. At December 31, 2016, the Bank could have declared additional dividends of approximately \$10.1 million without prior approval of regulatory authorities. As a result of this limitation, approximately \$73.9 million of the Company's investment in the Bank was restricted from transfer in the form of dividends.

**NOTE 20: AUBURN NATIONAL BANCORPORATION (PARENT COMPANY)**

The Parent Company's condensed balance sheets and related condensed statements of earnings and cash flows are as follows:

**CONDENSED BALANCE SHEETS**

<i>(Dollars in thousands)</i>	<b>December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Assets:</b>		
Cash and due from banks	\$ 2,190	2,187
Investment in bank subsidiary	83,984	85,529
Other assets	881	845
Total assets	\$ 87,055	88,561
<b>Liabilities:</b>		
Accrued expenses and other liabilities	\$ 1,661	1,395
Long-term debt	3,217	7,217
Total liabilities	4,878	8,612
Stockholders' equity	82,177	79,949
Total liabilities and stockholders' equity	\$ 87,055	88,561

**CONDENSED STATEMENTS OF EARNINGS**

<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Income:</b>		
Dividends from bank subsidiary	\$ 6,709	3,450
Noninterest income	129	135
Total income	6,838	3,585
<b>Expense:</b>		
Interest expense	228	236
Gain on early extinguishment of debt	(790)	—
Noninterest expense	193	195
Total expense	(369)	431
Earnings before income tax benefit and equity in undistributed earnings of bank subsidiary	7,207	3,154
Income tax expense (benefit)	157	(80)
Earnings before equity in undistributed earnings of bank subsidiary	7,050	3,234
Equity in undistributed earnings of bank subsidiary	1,100	4,624
<b>Net earnings</b>	<b>\$ 8,150</b>	<b>7,858</b>

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**CONDENSED STATEMENTS OF CASH FLOWS**

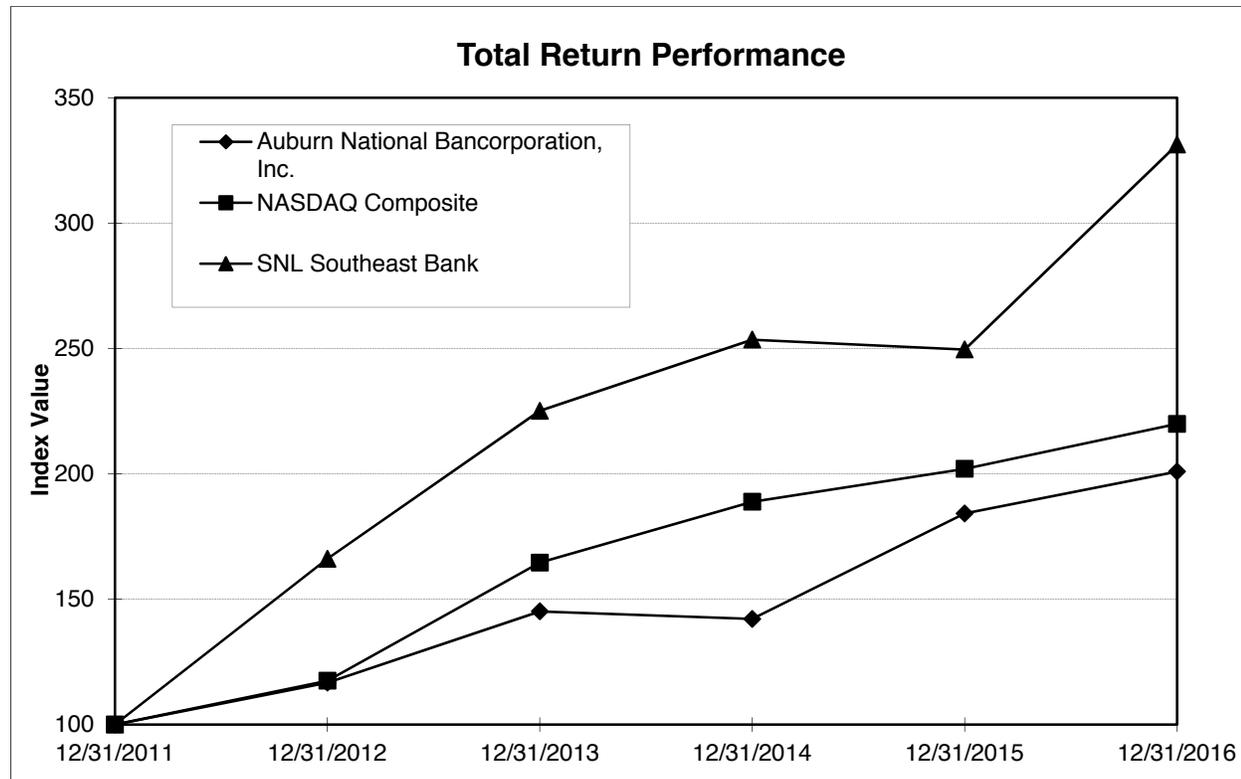
<i>(Dollars in thousands)</i>	<b>Year ended December 31</b>	
	<b>2016</b>	<b>2015</b>
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 8,150	7,858
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Gain on early extinguishment of debt	(790)	—
Net (increase) decrease in other assets	(36)	1
Net increase (decrease) in other liabilities	268	(153)
Equity in undistributed earnings of bank subsidiary	(1,100)	(4,624)
<b>Net cash provided by operating activities</b>	<b>6,492</b>	<b>3,082</b>
<b>Cash flows from financing activities:</b>		
Repayments or retirement of long-term debt	(3,210)	—
Dividends paid	(3,279)	(3,206)
<b>Net cash used in financing activities</b>	<b>(6,489)</b>	<b>(3,206)</b>
Net change in cash and cash equivalents	3	(124)
Cash and cash equivalents at beginning of period	2,187	2,311
<b>Cash and cash equivalents at end of period</b>	<b>\$ 2,190</b>	<b>2,187</b>

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### Stock Performance Graph

The following performance graph compares the cumulative, total return on the Company's Common Stock from December 31, 2011 to December 31, 2016, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a \$100 investment on December 31, 2011). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.



<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/11</b>	<b>12/31/12</b>	<b>12/31/13</b>	<b>12/31/14</b>	<b>12/31/15</b>	<b>12/31/16</b>
Auburn National Bancorporation, Inc.	100.00	116.70	145.12	142.12	184.18	200.90
NASDAQ Composite	100.00	117.45	164.57	188.84	201.98	219.89
SNL Southeast Bank	100.00	166.11	225.10	253.52	249.57	331.30



# Corporate Information

## Corporate Headquarters

100 N. Gay Street  
P.O. Box 3110  
Auburn, AL 36831-3110  
Phone: 334-821-9200  
Fax: 334-887-2796  
www.auburnbank.com

## Independent Auditors

Elliott Davis Decosimo LLC/PLLC  
200 East Broad Street  
Greenville, SC 29606

## Shareholder Services

Shareholders desiring to change the name, address or ownership of Auburn National Bancorporation, Inc. common stock or to report lost certificates should contact our Transfer Agent:

Computershare  
P. O. Box 30170  
College Station, TX 77842-3170  
Phone: 1-800-368-5948

For frequently asked questions, visit the Transfer Agent's home page at: [www.computershare.com](http://www.computershare.com)

## Annual Meeting

Tuesday, May 9, 2017  
3:00 p.m. (Central Time)  
AuburnBank Center  
132 N. Gay Street  
Auburn, AL 36830

## Investor Relations

A copy of the Company's annual report on Form 10-K, filed with the Securities and Exchange Commission (SEC), as well as our other SEC filings and our latest press releases are available free of charge through a link on our internet website at [www.auburnbank.com](http://www.auburnbank.com). Requests for these documents may also be made by emailing Investor Relations at [investorrelations@auburnbank.com](mailto:investorrelations@auburnbank.com) or by contacting Investor Relations by telephone or mail at the Company's corporate headquarters.

## Common Stock Listing

Auburn National Bancorporation, Inc. Common Stock is traded on the Nasdaq Global Market under the symbol AUBN.

## Dividend Reinvestment and Stock Purchase Plan

Auburn National Bancorporation, Inc. offers a Dividend Reinvestment Plan (DRIP) for automatic reinvestment of dividends in the stock of the company. Participants in the DRIP may also purchase additional shares with optional cash payments. For additional information or for an authorization form, please contact Investor Relations.

## Direct Deposit of Dividends

Dividends may be automatically deposited into a shareholder's checking or savings account free of charge. For more information, contact Investor Relations.



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